Internal Revenue
bulletin

Bulletin No. 2007-5
January 29, 2007

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. 2007–5, page 378.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through March 2007. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through March 2007.

Rev. Rul. 2007–6, page 393.

LIFO; price indexes; department stores. The November 2006 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, November 30, 2006.

T.D. 9303, page 379.
REG–125632–06, page 415.

Final, temporary, and proposed regulations under section 368 of the Code provide guidance regarding the qualification of certain transactions as reorganizations described in section 368(a)(1)(D) where no stock and/or securities of the acquiring corporation is issued and distributed in the transaction.

Notice 2007–9, page 401.

This notice provides guidance under section 954(c)(6) of the Code on dividend, interest, rent and royalty payments that may be excluded from foreign personal holding company income.

Notice 2007–13, page 410.

This notice announces that the Treasury Department and the Service will amend the regulations addressing substantial assistance rendered by a related person or persons to a controlled foreign corporation (CFC). These amended regulations will limit the types of activities that constitute substantial assistance to certain assistance rendered, directly or indirectly, by a United States person or persons to a related CFC. In addition, in light of the repeal of the foreign base company shipping income rules under subpart F, this notice confirms that income that previously was foreign base company shipping income will continue to be foreign base company income to the extent that it is within the definition of a remaining category of foreign base company income.

EMPLOYEE PLANS

T.D. 9302, page 382.

Final regulations under section 409(p) of the Code provide guidance concerning requirements for employee stock ownership plans (ESOPs) holding stock of Subchapter S corporations.

Notice 2007–7, page 395.

Distribution issues; multiple issues; Pension Protection Act of 2006. This notice provides guidance in the form of questions and answers with respect to certain provisions contained in the Pension Protection Act of 2006, Pub. L. No. 109–280 (PPA '06), that are effective in 2007 or earlier and are primarily related to distributions described in sections 303, 826, 828, 829, 845, 904, 1102, and 1201 of the statute.

Notice 2007–12, page 409.

Weighted average interest rate update; corporate bond indices; 30-year Treasury securities. The weighted average interest rate for January 2007 and the resulting permissible range of interest rates used to calculate current liability and to determine the required contribution are set forth.

(Continued on the next page)

Finding Lists begin on page ii.
Index for January begins on page iv.

Department of the Treasury
Internal Revenue Service

EXCISE TAX

Notice 2007–11, page 405.

This notice answers questions raised by Notice 2006–50, 2006–25 I.R.B. 1141. It also provides guidance regarding the standard amounts for individuals and provides rules for the Business and Nonprofit Estimation Method (EM). Notice 2006–50 amplified, clarified, and modified.

ADMINISTRATIVE

Rev. Proc. 2007–18, page 413.

Pursuant to section 1397E(e)(2) of the Code, this procedure sets forth the maximum face amount of Qualified Zone Academy Bonds that may be issued for each state for each of the calendar years 2006 and 2007. For this purpose, "State" includes the District of Columbia and the possessions of the United States.

Announcement 2007–8, page 416.

This document contains corrections to temporary regulations (T.D. 9286, 2006–43 I.R.B. 750) providing rules for claiming the railroad track maintenance credit under section 45G of the Code for qualified railroad track maintenance expenditures paid or incurred by a Class II or Class III railroad and other eligible taxpayers during the taxable year.

Announcement 2007–9, page 417.

This document contains corrections to final and temporary regulations (T.D. 9278, 2006–34 I.R.B. 256) regarding the treatment of controlled services transactions under section 482 of the Code and the allocation of income from intangibles, in particular with respect to contributions by a controlled party to the value of an intangible owned by another controlled party.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

Section 42.—Low-Income Housing Credit

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through March 2007. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through March 2007.

Rev. Rul. 2007–5

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

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

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period January through March 2007.

Table 1
Rev. Rul. 2007–5
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Jan '07	17.39	32.44	45.52	56.97	66.95	69.23	71.86	74.74	78.09	81.82	85.82
Feb '07	17.39	32.44	45.52	56.97	66.95	69.08	71.70	74.56	77.89	81.60	85.57
Mar '07	17.39	32.44	45.52	56.97	66.95	68.92	71.53	74.39	77.71	81.40	85.33

Table 1 (cont'd)
Rev. Rul. 2007–5
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	2004	2005	2006	2007							
Jan '07	89.79	93.41	96.70	97.21							
Feb '07	89.50	93.07	96.27	97.21							
Mar '07	89.22	92.75	95.89	97.21							

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3, 1998–1 C.B. 248; Rev. Rul. 2001–2, 2001–1 C.B. 255; Rev. Rul. 2001–53, 2001–2 C.B. 488; Rev. Rul. 2002–72, 2002–2 C.B. 759; Rev. Rul. 2003–117, 2003–2 C.B. 1051; Rev. Rul. 2004–100, 2004–2 C.B. 718; Rev. Rul. 2005–67, 2005–2 C.B. 771; and Rev. Rul. 2006–51, 2006–41 I.R.B. 632.

DRAFTING INFORMATION

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

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–2: Definition of terms.

T.D. 9303

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Corporate Reorganizations; Distributions Under Sections 368(a)(1)(D) and 354(b)(1)(B)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations under section 368 of the Internal Revenue Code of 1986 (Code). The temporary regulations provide guidance regarding the qualification of certain transactions as reorganizations described in section 368(a)(1)(D) where no stock and/or securities of the acquiring corporation is issued and distributed in the transaction. These regulations affect corporations engaging in such transactions and their shareholders. The text of the temporary regulations also serves as the text of the proposed regulations (REG–125632–06) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective on December 19, 2006.

Applicability Date: For dates of applicability, see §1.368–2T(l)(4)(i).

FOR FURTHER INFORMATION CONTACT: Bruce A. Decker at (202) 622–7550 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The IRS and Treasury Department have received requests for immediate guidance regarding whether certain acquisitive transactions can qualify as reorganizations described in section 368(a)(1)(D) where no stock of the transferee corporation is issued and distributed in the transaction. Currently, the IRS and Treasury Department are undertaking a broad study of issues related to acquisitive section 368(a)(1)(D) reorganizations. In the interest of efficient tax administration, the IRS and Treasury Department are issuing these temporary regulations to provide the requested certainty for taxpayers regarding these acquisitive transactions pending the broader study of issues. Although these rules also are being proposed in this issue of the Bulletin, the IRS and Treasury Department contemplate that the proposed rules may change upon completion of this broader study and the comments received.

The Code provides general nonrecognition treatment for reorganizations specifically described in section 368(a). Section 368(a)(1)(D) describes as a reorganization a transfer by a corporation (transferor corporation) of all or a part of its assets to another corporation (transferee corporation) if, immediately after the transfer, the transferor corporation or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the transferee corporation; but only if stock or securities of the controlled corporation are distributed in pursuance of a plan of reorganization in a transaction that qualifies under section 354, 355, or 356.

Section 354(a)(1) provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. Section 354(b)(1)(B) provides that section 354(a)(1) shall not apply to an exchange in pursuance of a plan of reorganization described in section 368(a)(1)(D) unless the transferee corporation acquires substantially all of the assets of the transferor corporation, and the stock, securities, and other properties received by such transferor corporation, as well as the other properties of such transferor corporation, are distributed in pursuance of the plan of reorganization.

Further, section 356 provides that if section 354 or 355 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 or 355 without the recognition of gain or loss but also of other property or money, then the gain, if any, to the recipient shall be recognized, but not in excess of the amount of money and fair market value of such other property. Accordingly, in the case of an acquisitive transaction, there can only be a distribution to which section 354 or 356 applies where the target shareholder(s) receive at least some property permitted to be received by section 354.

Notwithstanding the requirement in section 368(a)(1)(D) that "stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356", the IRS and the courts have not required the actual issuance and distribution of stock and/or securities of the transferee corporation in circumstances where the same person or persons own all the stock of the transferor corporation and the transferee corporation. In such circumstances, the IRS and the courts have viewed an issuance of stock to be a "meaningless gesture" not mandated by sections 368(a)(1)(D) and 354(b).

In Revenue Ruling 70–240, 1970–1 C.B. 81 (see §601.601(d)(2) of this chapter), B owned all of the stock of both corporation X and corporation Y. X sold its operating assets to Y for $34x dollars, which represented the fair market value of X's assets. X had $33x of other assets, consisting generally of cash, accounts receivables, and investments in stocks and bonds, so that the assets sold by X to Y constituted approximately 51% of X's total assets. Following the sale to Y, X paid its debts, which amounted to $38x, and then liquidated, distributing $29x to B, while Y continued to conduct the business formerly operated by X. The IRS concluded that "although no actual shares of the stock of Y were distributed to B as a result of the transaction, B is treated as having received Y stock since he already owned all the stock of Y." Accordingly, the IRS held that the sale of the operating assets by X to Y, followed by the liquidation and distribution of X's assets to B, resulted in a reorganization under section 368(a)(1)(D) and a distribution under section 356(a), despite the absence of an actual issuance and distribution of Y stock.

When considering a similar transaction between two corporations owned in identical proportions by a husband and wife, the Tax Court concluded that there was in substance an exchange of stock which meets the requirements of section 354 and 356, and stated, "[t]he issuance of further stock would have been a meaningless gesture, and we cannot conclude that the statute requires such a vain act." *James Armour, Inc. v. Commissioner*, 43 T.C. 295, 307 (1964). See also *Wilson v. Commissioner*, 46 T.C. 334 (1966). The IRS has also applied this meaningless gesture doctrine to circumstances where the transferor corporation and the transferee corporation are wholly owned by a single party directly or indirectly through subsidiaries, or as a result of family attribution pursuant to section 318(a)(1).

However, the application of this meaningless gesture doctrine has generally been limited to situations in which there is identical shareholder identity and proportionality of interest in the transferor corporation and the transferee corporation. For example, in *Warsaw Photographic Associates, Inc. v. Commissioner*, 84 T.C. 21 (1985), there was no issuance of stock by the transferee corporation to the transferor corporation, and the stock ownership in the two corporations was not identical. On the basis of these facts, the Tax Court concluded that the distribution of stock would not be a mere formality and refused to apply the meaningless gesture doctrine. Accordingly, the transaction failed to qualify as a section 368(a)(1)(D) reorganization because there was no distribution of stock of the transferee corporation under sections 368(a)(1)(D) and 354(b)(1)(B).

Explanation of Provisions

These temporary regulations provide guidance regarding the circumstances in which the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) is deemed satisfied despite the fact that no stock and/or securities are actually issued in a transaction otherwise described in section 368(a)(1)(D). In cases where the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions, these temporary regulations provide that the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) will be treated as satisfied even though no stock is actually issued in the transaction. For purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions, these temporary regulations provide that an individual and all members of his family that have a relationship described in section 318(a)(1) will be treated as one individual.

The temporary regulations also provide that the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) will be treated as satisfied in the absence of any issuance of stock and/or securities where there is a *de minimis* variation in shareholder identity or proportionality of ownership in the transferor and transferee corporations. Further, stock described in section 1504(a)(4) is disregarded for purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions.

Under these temporary regulations, in each case where it is determined that the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions, a nominal share of stock of the transferee corporation will be deemed issued in addition to the actual consideration exchanged in the transaction. The nominal share of stock in the transferee corporation will then be deemed distributed by the transferor corporation to its shareholders and, in appropriate circumstances, further transferred to the extent necessary to reflect the actual ownership of the transferor and transferee corporations.

These temporary regulations are being issued in response to requests for immediate guidance regarding whether transactions otherwise described in section 368(a)(1)(D) qualify as reorganizations where no stock and/or securities of the transferee corporation are actually issued in the transaction. The IRS and Treasury Department currently are undertaking a broad study of issues related to acquisitive reorganizations, including issues addressed by these temporary regulations. The IRS and Treasury Department are issuing these temporary regulations in order to provide certainty for taxpayers while these issues are under study.

The IRS and Treasury Department believe that these temporary regulations are a reasonable interpretation of section 368(a)(1)(D) and section 354(b)(1)(B) given the history of those provisions and the manner in which they have previously been interpreted by the courts and the IRS. However, no inference should be drawn from these temporary regulations regarding the law prior to the effective date of these temporary regulations. In this issue of the Bulletin, the IRS and Treasury Department are requesting comments on several issues relating to acquisitive reorganizations described in section 368(a)(1)(D).

In addition, the IRS and Treasury Department note that these temporary regulations do not expressly implement Prop. Reg. §1.368–1(f)(4) (FR 70, 11903–11912), which provides that there must be an exchange of net value except in the case of a transaction that would otherwise qualify as a reorganization described in section 368(a)(1)(D), provided that the fair market value of the property transferred to the acquiring corporation by the target corporation exceeds the amount of liabilities of the target corporation immediately before the exchange (including any liabilities cancelled, extinguished, or assumed in connection with the exchange), and the fair market value of the assets of the acquiring corporation equals or exceeds the amount of its liabilities immediately after the exchange. The solvency requirement remains the IRS's and Treasury Department's proposal but the IRS and Treasury Department continue to consider whether this solvency requirement should be applied to the transactions described in these temporary regulations.

Special Analyses

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

5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, 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 Bruce A. Decker of the Office of the Associate Chief Counsel (Corporate).

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.368–2 is amended by revising paragraph (l) to read as follows:

§1.368–2 Definition of terms.

* * * * *

(l) [Reserved]. For further guidance, see §1.368–2T(l).

Par. 3. Section 1.368–2T is added to read as follows:

§1.368–2T Definition of terms (temporary).

(a) through (k) [Reserved]. For further guidance, see §1.368–2(a) through (k).

(l) *Certain transactions treated as reorganizations described in section 368(a)(1)(D)*—(1) *General rule*. In order to qualify as a reorganization under section 368(a)(1)(D), a corporation (transferor corporation) must transfer all or part of its assets to another corporation (transferee corporation) and immediately after the transfer the transferor corporation, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, must be in control of the transferee corporation; but only if, in pursuance of the plan, stock or securities of the transferee are distributed in a transaction which qualifies under section 354, 355, or 356.

(2) *Distribution requirement*—(i) *In general*. For purposes of paragraph (l)(1) of this section, a transaction otherwise described in section 368(a)(1)(D) will be treated as satisfying the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) notwithstanding that there is no actual issuance of stock and/or securities of the transferee corporation if the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions. In such cases, the transferee corporation will be deemed to issue a nominal share of stock to the transferor corporation in addition to the actual consideration exchanged for the transferor corporation's assets. The nominal share of stock in the transferee corporation will then be deemed distributed by the transferor corporation to its shareholders and, where appropriate, further transferred through chains of ownership to the extent necessary to reflect the actual ownership of the transferor and transferee corporations.

(ii) *Attribution*. For purposes of paragraph (l)(2)(i) of this section, ownership of stock will be determined by applying the principles of section 318(a)(2) without regard to the 50 percent limitation in section 318(a)(2)(C). In addition, an individual and all members of his family described in section 318(a)(1) shall be treated as one individual.

(iii) *De minimis variations in ownership and certain stock not taken into account*. For purposes of paragraph (l)(2)(i) of this section, the same person or persons will be treated as owning, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions notwithstanding the fact that there is a *de minimis* variation in shareholder identity or proportionality of ownership. Additionally, for purposes of paragraph (l)(2)(i) of this section, stock described in section 1504(a)(4) is not taken into account.

(3) *Examples.* The following examples illustrate the principles of paragraph (l) of this section. For purposes of these examples, each of A, B, C, and D is an individual, T is the acquired corporation, S is the acquiring corporation, P is the parent corporation, and each of S1, S2, S3, and S4 is a direct or indirect subsidiary of P. Further, all of the requirements of section 368(a)(1)(D) other than the requirement that stock or securities be distributed in a transaction to which section 354 or 356 applies are satisfied. The examples are as follows:

Example 1. A owns all the stock of T and S. The T stock has a fair market value of $100x. T sells all of its assets to S in exchange for $100x of cash and immediately liquidates. Because there is complete shareholder identity and proportionality of ownership in T and S, under paragraph (l)(2)(i) of this section, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the $100x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to A. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 2. The facts are the same as in *Example 1* except that C, A's son, owns all of the stock of S. Under paragraph (l)(2)(ii) of this section, A and C are treated as one individual. Accordingly, there is complete shareholder identity and proportionality of ownership in T and S. Therefore, under paragraph (l)(2)(i) of this section, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the $100x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to A. A will be deemed to transfer the nominal share of S stock to C. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 3. P owns all of the stock of S1 and S2. S1 owns all of the stock of S3, which owns all of the stock of T. S2 owns all of the stock of S4, which owns all of the stock of S. The T stock has a fair market value of $70x. T sells all of its assets to S in exchange for $70x of cash and immediately liquidates. Under paragraph (l)(2)(ii) of this section, there is indirect, complete shareholder identity and proportionality of ownership in T and S. Accordingly, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the $70x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to S3. S3 will be deemed to distribute the nominal share of S stock to S1, which, in turn, will be deemed to distribute the nominal share of S stock to P. P will be deemed to transfer the nominal share of S stock to S2, which, in turn, will be deemed to transfer such share of S stock to S4. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 4. A, B, and C own 34%, 33%, and 33%, respectively, of the stock of T. The T stock has a fair market value of $100x. A, B, and C each own 33% of the stock of S. D owns the remaining 1% of the stock of S. T sells all of its assets to S in exchange for $100x of cash and immediately liquidates. For purposes of determining whether the distribution requirement of sections 368(a)(1)(D) and 354(b)(1)(B) is met, under paragraph (l)(2)(iii) of this section, D's ownership of a *de minimis* amount of stock of S is disregarded and the transaction is treated as if there is complete shareholder identity and proportionality of ownership in T and S. Because there is complete shareholder identity and proportionality of ownership in T and S, under paragraph (l)(2)(i) of this section, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the $100x of cash actually exchanged for the T assets, T will be deemed to distribute all such consideration to A, B, and C, and the nominal S stock will be deemed transferred among the S shareholders to the extent necessary to reflect their actual ownership of S. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 5. The facts are the same as in *Example 4* except that A, B, and C own 34%, 33%, and 33%, respectively, of the common stock of T and S. D owns preferred stock in S described in section 1504(a)(4). For purposes of determining whether the distribution requirement of sections 368(a)(1)(D) and 354(b)(1)(B) is met, under paragraph (l)(2)(iii) of this section, D's ownership of S stock described in section 1504(a)(4) is ignored and the transaction is treated as if there is complete shareholder identity and proportionality of ownership in T and S. Because there is complete shareholder identity and proportionality of ownership in T and S, under paragraph (l)(2)(i) of this section, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the $100x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to A, B, and C. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 6. A and B each own 50% of the stock of T. The T stock has a fair market value of $100x. B and C own 90% and 10%, respectively, of the stock of S. T sells all of its assets to S in exchange for $100x of cash and immediately liquidates. Because complete shareholder identity and proportionality of ownership in T and S does not exist, paragraph (l)(2)(i) of this section does not apply. The requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are not satisfied, and the transaction does not qualify as a reorganization described in section 368(a)(1)(D).

(4) *Effective date.* (i) *In general.* This section applies to transactions occurring on or after March 19, 2007, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding before December 19, 2006, and at all times thereafter. A taxpayer may apply the provisions of these temporary regulations to transactions occurring before March 19, 2007. However, the transferor corporation, the transferee corporation, any direct or indirect transferee of transferred basis property from either of the foregoing, and any shareholder of the transferor or transferee corporation may not apply the provisions of these temporary regulations unless all such taxpayers apply the provisions of the temporary regulations.

(ii) *Expiration.* This section expires on or before December 18, 2009.

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

Approved December 6, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 18, 2006, 8:45 a.m., and published in the issue of the Federal Register for December 19, 2006, 71 F.R. 75879)

Section 409.—Qualifications for Tax Credit Employee Stock Ownership Plans

26 CFR 1.409(p)–1: Prohibited allocation of securities in an S corporation.

T.D. 9302

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Prohibited Allocations of Securities in an S Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance concerning requirements under section 409(p) of the Internal Revenue Code for employee stock ownership plans (ESOPs) holding stock of Subchapter S corporations. These final regulations generally affect plan sponsors of, and participants in, ESOPs holding stock of Subchapter S corporations.

DATES: *Effective Date:* These regulations are effective December 20, 2006.

Applicability Dates: These regulations are generally applicable with respect to plan years beginning on or after January 1, 2006. See the Effective Date section of the preamble for specific information.

FOR FURTHER INFORMATION CONTACT: John T. Ricotta or Veronica A. Rouse at (202) 622–6090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations (26 CFR Part 1) under section 409(p) of the Internal Revenue Code (Code).

Section 409(p)(1) requires an ESOP holding employer securities consisting of stock in an S corporation to provide that, during an allocation year, no portion of the assets of the plan attributable to, or allocable in lieu of, the employer securities may accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a)) for the benefit of any disqualified person. Section 409(p)(3)(A) provides that a nonallocation year includes any plan year during which the ownership of the S corporation is so concentrated among disqualified persons that they own or are deemed to own at least 50 percent of its shares. Section 409(p)(4) provides, in general, that a disqualified person is any person whose deemed-owned ESOP shares (allocated ESOP shares and proportion of suspense account shares) are at least 10 percent of the number of deemed-owned shares of S corporation stock held by an ESOP or for whom the aggregate number of shares owned by such person and the members of such person's family is at least 20 percent of deemed-owned ESOP shares. Under section 409(p)(5), the determination of whether a person is a disqualified person and whether a plan year is a nonallocation year is also made separately taking into account synthetic equity if such treatment results in treating the person as a disqualified person or the year as a nonallocation year.

Temporary regulations (T.D. 9081, 2003–2 C.B. 420) under section 409(p) were issued on July 21, 2003, (68 FR 42970). The text of those temporary regulations also served as the text of a notice of proposed rulemaking (REG–129709–03, 2003–2 C.B. 506) published at 68 FR 43058. The 2003 regulations provided guidance on identifying disqualified persons, determining whether an ESOP has a nonallocation year, and defining synthetic equity under section 409(p)(5), and reserved some issues, including the definition of a prohibited allocation, the tax effect of a prohibited allocation, and certain issues relating to the definition of synthetic equity.

A public hearing on the 2003 regulations was held on November 17, 2003. New temporary regulations under section 409(p) (T.D. 9164, 2005–1 C.B. 320) were published in the **Federal Register** on December 17, 2004, (69 FR 75455). The new temporary regulations (2004 temporary regulations) addressed certain issues raised in the comments, as well as addressing the topics reserved in the 2003 temporary regulations. The text of the 2004 temporary regulations also served as the text for a notice of proposed rulemaking (REG–129709–03, 2005–1 C.B. 351) published at 69 FR 75492.

A public hearing on the 2004 proposed regulations was held on April 20, 2005. After consideration of the comments received, these final regulations adopt the provisions of the proposed regulations with certain modifications discussed in this preamble.

Explanation of Provisions

Definition of Prohibited Allocation

These regulations retain the rule of the 2004 temporary regulations concerning prohibited allocations under which there is an impermissible accrual to the extent employer securities consisting of stock in an S corporation are held under the ESOP for the benefit of a disqualified person during a nonallocation year. Thus, in the event of a nonallocation year, S corporation shares held in a disqualified person's account and all other ESOP assets attributable to S corporation stock, including distributions, sales proceeds, and earnings, are treated as an impermissible accrual whether attributable to contributions in the current year or a prior year. A commentator questioned whether the definition of prohibited allocation in the 2004 temporary regulations should include account balances of disqualified persons from prior years. The rule of the 2004 temporary regulations has been retained because it is consistent with the intent of the statute, and the IRS and Treasury Department believe it is necessary to prevent the concentration of ownership interests that section 409(p) was intended to prevent.

A commentator also questioned the treatment of proceeds from the sale of stock previously allocated to a disqualified person's account under the 2004 temporary regulations. The commentator expressed concern that treating the sales proceeds as an impermissible accrual when the original allocation of stock is already a prohibited allocation is a double penalty. The final regulations do not change this rule in the 2004 temporary regulations. An allocation of sales proceeds from stock held for the benefit of a disqualified person back into the account of the disqualified person is as valuable an accrual for the disqualified person as an investment in employer stock. This treatment is also consistent with the prohibition in section 409(p)(1) with respect to amounts that are "allocable in lieu of" employer stock.

Effect of a Prohibited Allocation

These regulations retain the rule of the 2004 regulations that if there is a prohibited allocation during a nonallocation year, the ESOP fails to satisfy the requirements of section 4975(e)(7) and ceases to be an ESOP. As a result, the exemption from the excise tax on prohibited transactions for loans to leveraged ESOPs contained in section 4975(d)(3) would cease to apply to any loan (with the result that the employer would owe an excise tax with respect to the previously exempt loan). These regulations clarify that an additional result would be the plan's failure to satisfy the qualification requirements under section 401(a) for not operating the plan in accordance with its terms to reflect section 409(p). Other consequences include imposition of an excise tax on the S corporation under section 4979A. An example has been added to these final regulations to illustrate the impact of these rules on an S corporation ESOP.

These regulations include the rule from the 2004 regulations under which a prohibited allocation is a deemed distribution that is not an eligible rollover distribution. These regulations also add that same rule to the list of distributions that are not eligible rollover distributions in the regulations under section 402(c) (at §1.402(c)–2 of the Treasury Regulations). As a result, under recently proposed regulations relating to designated Roth contributions under section 402A, a deemed distribution as a result of a section 409(p) prohibited allocation with respect to a designated Roth account would not constitute a qualified distribution for purposes of section 402A. See proposed §1.402A–1, A–11, at 71 FR 4320 (January 26, 2006).

Prevention of Nonallocation Year

The preamble to the 2004 regulations described methods that a plan might use to prevent the occurrence of a nonallocation year, including (1) a reduction of synthetic equity (for example, through cancellation or distribution), (2) a sale of the S corporation securities held in the participant's ESOP account before a nonallocation year occurs so that the account is not invested in S corporation stock, or (3) a transfer of the S corporation securities held for the participant under the ESOP into a separate portion of the plan that is not an ESOP or to another qualified plan of the employer that is not an ESOP.

Any methods of preventing a nonallocation year must satisfy applicable legal and qualification requirements, including the nondiscrimination requirements of section 401(a)(4) (including the rules at §1.401(a)(4)–4 relating to benefits, rights and features), and implementation of these methods must be completed before a nonallocation year occurs. These regulations retain the special rule provided in the 2004 regulations for applying the nondiscrimination requirements under section 401(a)(4) for a plan that uses the transfer method. Thus, these regulations provide that, if a transfer is made from an ESOP to a separate portion of the plan (or to another qualified plan of the employer) that is not an ESOP in order to prevent a nonallocation year, then both the ESOP and the plan that is not an ESOP will not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the transfer. Similarly, these regulations provide that, subsequent to the transfer, the plan will not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the benefits, rights, and features with respect to the transferred benefits if those benefits, rights, and features would satisfy the requirements of §1.401(a)(4)–4 if the mandatory disaggregation rule for ESOPs at §1.410(b)–7(c)(2) did not apply. These regulations clarify that any such transfers must be effectuated by an affirmative action taken no later than the date of the transfer, and all subsequent actions (including benefit statements) must be consistent with the transfer having occurred on that date. Further, in order to use the transfer method to prevent a nonallocation year, the plan must provide for the transfer of the stock to the non-ESOP portion of the plan.

A commentator described another method of preventing a nonallocation year under which stock of a participant is exchanged for cash or other assets, which are already in the accounts of other participants in order to change the stock holdings among participants before a nonallocation year occurs, but which does not change the overall stock holding of the ESOP trust. This method has been referred to as reshuffling. The commentator requested that relief from the nondiscriminatory availability requirements be extended to this method.

Absent a special rule for applying the nondiscrimination requirements of section 401(a)(4), it will be difficult for a plan to prevent a nonallocation year through reshuffling without violating section 401(a)(4). The right of each participant to have or not have a particular investment in his or her account (either as a participant-directed investment or as a trustee-directed investment) is a plan right or feature that is subject to the current and effective availability requirements of §1.401(a)(4)–4. Accordingly, if assets in the accounts of one or more non-highly compensated employees (NHCEs) are mandatorily exchanged, then, in the absence of other relevant factors, the plan would generally be expected to fail to satisfy the nondiscriminatory availability requirements of §1.401(a)(4)–4.

The IRS and Treasury Department do not believe that it would be appropriate to provide a special rule that would materially weaken the standard for nondiscriminatory availability of participant rights to a particular investment under the plan. By contrast, the special nondiscrimination rules for stock transferred out of the ESOP do not change the rights of NHCEs to any particular investment in the plan as a whole, but simply allow the transfer and allow the rights of participants whose stock is transferred out of the ESOP to be taken into account in determining whether the rights of participants whose stock remains in the ESOP satisfy the nondiscriminatory availability requirements of §1.401(a)(4)–4.

An S corporation may be able to achieve the same result as reshuffling by reducing contributions for HCEs who are or may become disqualified persons, by providing additional benefits to NHCEs who are not disqualified persons, by expanding coverage to include all employees, or by diversifying out of employer stock for HCEs who are or may become disqualified persons and who are qualified participants within the meaning of section 401(a)(28)(B)(iii) (that is, by mandating diversification using one of the diversification options that are offered to all qualified participants, for which there is an existing special nondiscrimination rule at §1.401(a)(4)–4(d)(6)). Thus, in addition to plan transfers, any of these actions may help prevent the concentration of deemed-owned ESOP shares that section 409(p) prohibits, without the nondiscrimination problems otherwise associated with reshuffling. Of course, any transfer or other method used to ensure compliance with section 409(p) must also satisfy any other legal requirements that may apply, including section 407(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 829) Public Law 93–406 (which, in relevant part, generally prohibits a plan from investing more than 10 percent of elective deferral accounts in employer stock, unless the plan is an ESOP, the investment is at the direction of the participant, or another exception applies).

Treatment of Family Members as Disqualified Persons

The 2004 regulations included a number of attribution rules, which these regulations retain, including the application of the section 318 attribution rules to ownership of synthetic equity in determining who is a disqualified person. Section 409(p) contains references to the section 318 rules in certain cases, such as in determining a nonallocation year, but commentators pointed out that the section 318 rules did not apply for purposes of the disqualified person definition, which was not reflected in an example. Another commentator pointed out that the rules for determining whether family members are disqualified persons varies according to the individual being tested. For example, the technical language of section 409(p)(4)(D) treats parents-in-law as members of a married child's family when testing whether a child is a disqualified person, but not as members of the same family as the child's parents when testing whether the child's parents are disqualified persons. In response to comments, the regulations have been modified to clarify these rules, including revisions in the examples to illustrate the application of the rules to specific factual patterns.

Determination of Number of Shares of Non-Stock-Based Synthetic Equity

These regulations retain the rules from both the 2003 and the 2004 regulations regarding calculation of the number of shares of synthetic equity that are not determined by reference to shares of stock of the S corporation. These regulations provide that the person who is entitled to the synthetic equity is treated as owning a number of shares of stock in the S corporation equal to the present value of the synthetic equity (with such value determined without regard to any lapse restriction as defined under the section 83 regulations) divided by the fair market value of a share of the S corporation's stock as of the same date. These regulations also retain the special rule under the 2004 regulations that permits the ESOP to provide, on a reasonable and consistent basis for all persons, for the number of synthetic equity shares treated as owned on a determination date to remain constant for up to a 3-year period from that date (triennial method). This rule addresses concerns raised in comments to the 2003 regulations regarding the volatility of the number of shares of synthetic equity where that calculation is based on the value of an S corporation share.

A commentator questioned whether the triennial method of the 2004 regulations should be expanded to permit a more flexible triennial period that allows for the acceleration or delay of the triennial determination date. The commentator argued that, since the triennial method's purpose is to eliminate the risk attributable to volatility of the present value of the nonqualified deferred compensation stock and the risk attributable to the fair market value of company stock, the inability to delay or accelerate the date, automatically and daily if necessary, weakens the purpose of the method.

These regulations include changes in the triennial methodology to permit the ability, during the 3-year period, to accelerate a determination date prospectively in the event of a change in the plan year or any merger, consolidation, or transfer of ESOP assets under section 414(l). However, a determination date may not be changed retroactively and the change must be effectuated by a plan amendment adopted before the new determination date.[1]

A commentator also requested clarification regarding how shares of synthetic equity are calculated with respect to nonqualified deferred compensation. Specifically, the commentator wanted to know what discount rate should be used to calculate the present value of nonqualified deferred compensation, and how to determine the number of equivalent shares for a split-dollar life insurance arrangement. These regulations do not mandate a specific discount rate for calculating the present value of nonqualified deferred compensation or a specific method for determining the equivalent number of shares for a split dollar arrangement. However, any assumptions used for such purposes must be reasonable.

Finally, a commentator asked whether an individual S corporation shareholder's right of first refusal to acquire S corporation stock from an ESOP for its fair market value is considered synthetic equity. The regulations have been revised to clarify that the right of first refusal to acquire stock held by an ESOP is not treated as a right to acquire stock of an S corporation under these regulations if the right to acquire stock would not be taken into account under §1.1361–1(l)(2)(iii)(A) in determining whether an S corporation has a second class of stock and the price at which the stock is acquired under the right of first refusal is not less than the price determined for purposes of the put right required by section 409(h). See §54.4975–11(d)(5) of the Excise Tax Regulations. Of course, any right of first refusal must comply with the requirements of §54.4975–7(b)(9) of the Excise Tax Regulations. In addition, these regulations give the Commissioner the authority to treat a right of first refusal as synthetic equity if the Commissioner determines, based on the facts and circumstances, that the right to acquire stock held by the ESOP constitutes an avoidance or evasion of section 409(p).

Effective Dates

These regulations generally are applicable for plan years beginning on or after January 1, 2006. However, these regulations retain, by cross reference, the 2004 regulations for plan years beginning before January 1, 2006.

Special Analyses

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

Drafting Information

The principal authors of these regulations are John T. Ricotta and Veronica A. Rouse of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities); however, other personnel from the IRS and Treasury participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.409(p)–1 is also issued under 26 U.S.C. 409(p)(7). * * *

Par. 2. Section 1.402(c)–2, A–4, is revised by redesignating paragraph (g) as (h) and adding a new paragraph (g) to read as follows:

§1.402(c)–2 Eligible rollover distributions; questions and answers.

* * * * *

A–4. * * *

(g) Prohibited allocations that are treated as deemed distributions pursuant to section 409(p). * * *

Par. 3. Section 1.409(p)–1 is added to read as follows:

§1.409(p)–1 Prohibited allocation of securities in an S corporation.

(a) *Organization of this section and definition*—(1) *Organization of this section.* Section 409(p) applies if a nonallocation year occurs in an ESOP that holds shares of stock of an S corporation that are employer securities. Paragraph (b) of this section sets forth the general rule under section 409(p)(1) and (2) prohibiting any accrual or allocation to a disqualified person in a nonallocation year. Paragraph (c) of this section sets forth rules under section 409(p)(3), (5), and (7) for determining whether a year is a nonallocation year, generally based on whether disqualified persons own at least 50 percent of the shares of the S corporation, either taking into account only the outstanding shares of the S corporation (including shares held by the

[1] As indicated in Notice 2005–95, 2005–2 C.B. 1172, dated December 19, 2005, the general deadline for discretionary amendments in Rev. Proc. 2005–66, 2005–2 C.B. 509, does not apply if a statute or regulation specifically provides an earlier deadline. These regulations provide such an earlier deadline.

ESOP) or taking into account both the outstanding shares and synthetic equity of the S corporation. Paragraphs (d), (e), and (f) of this section contain definitions of disqualified person under section 409(p)(4) and (5), deemed-owned ESOP shares under section 409(p)(4)(C), and synthetic equity under section 409(p)(6)(C). Paragraph (g) of this section contains a standard for determining when the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p).

(2) *Definitions*. The following definitions apply for purposes of section 409(p) and this section, as well as for purposes of section 4979A, which imposes an excise tax on certain events.

(i) *Deemed-owned ESOP shares* has the meaning set forth in paragraph (e) of this section.

(ii) *Disqualified person* has the meaning set forth in paragraph (d) of this section.

(iii) *Employer* has the meaning set forth in §1.410(b)–9.

(iv) *Employer securities* means employer securities within the meaning of section 409(l).

(v) *ESOP* means an employee stock ownership plan within the meaning of section 4975(e)(7).

(vi) *Prohibited allocation* has the meaning set forth in paragraph (b)(2) of this section.

(vii) *S corporation* means S corporation within the meaning of section 1361.

(viii) *Synthetic equity* has the meaning set forth in paragraph (f) of this section.

(b) *Prohibited allocation in a nonallocation year*—(1) *General rule*. Section 409(p)(1) provides that an ESOP holding employer securities consisting of stock in an S corporation must provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue under the ESOP, or be allocated directly or indirectly under any plan of the employer (including the ESOP) meeting the requirements of section 401(a), for the benefit of any disqualified person.

(2) *Additional rules*—(i) *Prohibited allocation definition*. For purposes of section 409(p) and this section, a *prohibited allocation* means an impermissible accrual or an impermissible allocation. Whether there is impermissible accrual is determined under paragraph (b)(2)(ii) of this section and whether there is an impermissible allocation is determined under paragraph (b)(2)(iii) of this section. The amount of the prohibited allocation is equal to the sum of the amount of the impermissible accrual plus the amount of the impermissible allocation.

(ii) *Impermissible accrual*. There is an impermissible accrual to the extent that employer securities consisting of stock in an S corporation owned by the ESOP and any assets attributable thereto are held under the ESOP for the benefit of a disqualified person during a nonallocation year. For this purpose, assets attributable to stock in an S corporation owned by an ESOP include any distributions, within the meaning of section 1368, made on S corporation stock held in a disqualified person's account in the ESOP (including earnings thereon), plus any proceeds from the sale of S corporation securities held for a disqualified person's account in the ESOP (including any earnings thereon). Thus, in the event of a nonallocation year, all S corporation shares and all other ESOP assets attributable to S corporation stock, including distributions, sales proceeds, and earnings on either distributions or proceeds, held for the account of such disqualified person in the ESOP during that year are an impermissible accrual for the benefit of that person, whether attributable to contributions in the current year or in prior years.

(iii) *Impermissible allocation*. An impermissible allocation occurs during a nonallocation year to the extent that a contribution or other annual addition (within the meaning of section 415(c)(2)) is made with respect to the account of a disqualified person, or the disqualified person otherwise accrues additional benefits, directly or indirectly under the ESOP or any other plan of the employer qualified under section 401(a) (including a release and allocation of assets from a suspense account, as described at §54.4975–11(c) and (d) of this chapter) that, for the nonallocation year, would have been added to the account of the disqualified person under the ESOP and invested in employer securities consisting of stock in an S corporation owned by the ESOP but for a provision in the ESOP that precludes such addition to the account of the disqualified person, and investment in employer securities during a nonallocation year.

(iv) *Effects of prohibited allocation*—(A) *Deemed distribution*. If a plan year is a nonallocation year, the amount of any prohibited allocation in the account of a disqualified person as of the first day of the plan year, as determined under this paragraph (b)(2), is treated as distributed from the ESOP (or other plan of the employer) to the disqualified person on the first day of the plan year. In the case of an impermissible accrual or impermissible allocation that is not in the account of the disqualified person as of the first day of the plan year, the amount of the prohibited allocation, as determined under this paragraph (b)(2), is treated as distributed on the date of the prohibited allocation. Thus, the fair market value of assets in the disqualified person's account that constitutes an impermissible accrual or allocation is included in gross income (to the extent in excess of any investment in the contract allocable to such amount) and is subject to any additional income tax that applies under section 72(t). A deemed distribution under this paragraph (b)(2)(iv)(A) is not an actual distribution from the ESOP. Thus, the amount of the prohibited allocation is not an eligible rollover distribution under section 402(c). However, for purposes of applying sections 72 and 402 with respect to any subsequent distribution from the ESOP, the amount that the disqualified person previously took into account as income as a result of the deemed distribution is treated as investment in the contract.

(B) *Other effects*. If there is a prohibited allocation, then the plan fails to satisfy the requirements of section 4975(e)(7) and ceases to be an ESOP. In such a case, the exemption from the excise tax on prohibited transactions for loans to leveraged ESOPs contained in section 4975(d)(3) would cease to apply to any loan (with the result that the employer would owe an excise tax with respect to the previously exempt loan). As a result of these failures, the plan would lose the prohibited transaction exemption for loans to an ESOP under section 4975(d)(3) of the Code and section 408(b)(3) of Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Finally, a plan that does not operate in accordance with its terms to reflect section 409(p) fails to satisfy the qualification requirements of section 401(a), which would cause the corporation's S election to terminate under section 1362. See also section 4979A(a) which imposes an excise tax in certain events, including a prohibited allocation under section 409(p).

(C) *Example*. The rules of this paragraph (b)(2)(iv) are illustrated by the following example:

Example. (i) *Facts*. Corporation M, an S corporation under section 1361, establishes Plan P as an ESOP in 2006, with a calendar plan year. Plan P is a qualified plan that includes terms providing that a prohibited allocation will not occur during a nonallocation year in accordance with section 409(p). On December 31, 2006, all of the 1,000 outstanding shares of stock of Corporation M, with a fair market value of $30 per share, are contributed to Plan P and allocated among accounts established within Plan P for the benefit of Corporation M's three employees, individuals A, B, and C, based on their compensation for 2006. As a result, on December 31, 2006, participant A's account includes 800 of the shares ($24,000); participant B's account includes 140 of the shares ($4,200); and participant C's account includes the remaining 60 shares ($1,800). The plan year 2006 is a nonallocation year, participants A and B are disqualified persons on December 31, 2006, and a prohibited allocation occurs for A and B on December 31, 2006.

(ii) *Conclusion*. On December 31, 2006, participants A and B each have a deemed distribution as a result of the prohibited allocation, resulting in income of $24,000 for participant A and $4,200 for participant B. Corporation M owes an excise tax under section 4979A, based on an amount involved of $28,200. Plan P ceases to be an ESOP on the date of the prohibited allocation (December 31, 2006) and also fails to satisfy the qualification requirements of section 401(a) on that date due to the failure to comply with the provisions requiring compliance with section 409(p). As a result of having an ineligible shareholder under section 1361(b)(1)(B), Corporation M ceases to be an S corporation under section 1361 on December 31, 2006.

(v) *Prevention of prohibited allocation*—(A) *Transfer of account to non-ESOP*. An ESOP may prevent a nonallocation year or a prohibited allocation during a nonallocation year by providing for assets (including S corporation securities) allocated to the account of a disqualified person (or a person reasonably expected to become a disqualified person absent a transfer described in this paragraph (b)(2)(v)(A)) to be transferred into a separate portion of the plan that is not an ESOP, as described in §54.4975–11(a)(5) of this chapter, or to another plan of the employer that satisfies the requirements of section 401(a) and that is not an ESOP. Any such transfer must be effectuated by an affirmative action taken no later than the date of the transfer, and all subsequent actions (including benefit statements) generally must be consistent with the transfer having occurred on that date. In the event of such a transfer involving S corporation securities, the recipient plan is subject to tax on unrelated business taxable income under section 512.

(B) *Relief from nondiscrimination requirement*. Pursuant to this paragraph (b)(2)(v)(B), if a transfer described in paragraph (b)(2)(v)(A) of this section is made from an ESOP to a separate portion of the plan or to another qualified plan of the employer that is not an ESOP, then both the ESOP and the plan or portion of a plan that is not an ESOP do not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the transfer. Further, subsequent to the transfer, that plan will not fail to satisfy the requirements of §1.401(a)(4)–4 merely because of the benefits, rights, and features with respect to the transferred benefits if those benefits, rights, and features would satisfy the requirements of §1.401(a)(4)–4 if the mandatory disaggregation rule for ESOPs at §1.410(b)–7(c)(2) did not apply.

(c) *Nonallocation year*. A year is a nonallocation year if it is described in the general definition in paragraph (c)(1) of this section or if the special rule of paragraph (c)(3) of this section applies.

(1) *General definition*. For purposes of section 409(p) and this section, a *nonallocation year* means a plan year of an ESOP during which, at any time, the ESOP holds any employer securities that are shares of an S corporation and either—

(i) Disqualified persons own at least 50 percent of the number of outstanding shares of stock in the S corporation (including deemed-owned ESOP shares); or

(ii) Disqualified persons own at least 50 percent of the sum of:

(A) The outstanding shares of stock in the S corporation (including deemed-owned ESOP shares); and

(B) The shares of synthetic equity in the S corporation owned by disqualified persons.

(2) *Attribution rules*. For purposes of this paragraph (c), the rules of section 318(a) apply to determine ownership of shares in the S corporation (including deemed-owned ESOP shares) and synthetic equity. However, for this purpose, section 318(a)(4) (relating to options to acquire stock) is disregarded and, in applying section 318(a)(1), the members of an individual's family include members of the individual's family under paragraph (d)(2) of this section. In addition, an individual is treated as owning deemed-owned ESOP shares of that individual notwithstanding the employee trust exception in section 318(a)(2)(B)(i). If the attribution rules in paragraph (f)(1) of this section apply, then the rules of paragraph (f)(1) of this section are applied before (and in addition to) the rules of this paragraph (c)(2).

(3) *Special rule for avoidance or evasion*. (i) Any ownership structure described in paragraph (g)(3) of this section results in a nonallocation year. In addition, each individual referred to in paragraph (g)(3) of this section is treated as a disqualified person and the individual's interest in the separate entity described in paragraph (g)(3) of this section is treated as synthetic equity.

(ii) Pursuant to section 409(p)(7)(B), the Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), may provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p). For any year that is a nonallocation year under this paragraph (c)(3), the Commissioner may treat any person as a disqualified person. See paragraph (g) of this section for guidance regarding when the principal purpose of an ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p).

(4) *Special rule for certain stock rights*. (i) For purposes of paragraph (c)(1) of this section, a person is treated as owning stock if the person has an exercisable right to acquire the stock, the stock is both issued and outstanding, and the stock is held by persons other than the ESOP, the S corporation, or a related entity (as defined in paragraph (f)(3) of this section).

(ii) This paragraph (c)(4) applies only if treating persons as owning the shares described in paragraph (c)(4)(i) of this section results in a nonallocation year. This paragraph (c)(4) does not apply to a right to acquire stock of an S corporation held by a shareholder that is subject to Federal income tax that, under

§1.1361–1(l)(2)(iii)(A) or (l)(4)(iii)(C), would not be taken into account in determining if an S corporation has a second class of stock, provided that a principal purpose of the right is not the avoidance or evasion of section 409(p). Under the last sentence of paragraph (f)(2)(i) of this section, this paragraph (c)(4)(ii) does not apply for purposes of determining ownership of deemed-owned ESOP shares or whether an interest constitutes synthetic equity.

(5) *Application with respect to shares treated as owned by more than one person*. For purposes of applying paragraph (c)(1) of this section, if, by application of the rules of paragraph (c)(2), (c)(4), or (f)(1) of this section, any share is treated as owned by more than one person, then that share is counted as a single share and that share is treated as owned by disqualified persons if any of the owners is a disqualified person.

(6) *Effect of nonallocation year*. See paragraph (b) of this section for a prohibition applicable during a nonallocation year. See also section 4979A for an excise tax applicable in certain cases, including section 4979A(a)(3) and (4) which applies during a nonallocation year (whether or not there is a prohibited allocation during the year).

(d) *Disqualified persons*. A person is a disqualified person if the person is described in paragraph (d)(1), (d)(2), or (d)(3) of this section.

(1) *General definition*. For purposes of section 409(p) and this section, a *disqualified person* means any person for whom—

(i) The number of such person's deemed-owned ESOP shares of the S corporation is at least 10 percent of the number of the deemed-owned ESOP shares of the S corporation;

(ii) The aggregate number of such person's deemed-owned ESOP shares and synthetic equity shares of the S corporation is at least 10 percent of the sum of—

(A) The total number of deemed-owned ESOP shares of the S corporation; and

(B) The person's synthetic equity shares of the S corporation;

(iii) The aggregate number of the S corporation's deemed-owned ESOP shares of such person and of the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares of the S corporation; or

(iv) The aggregate number of the S corporation's deemed-owned ESOP shares and synthetic equity shares of such person and of the members of such person's family is at least 20 percent of the sum of—

(A) The total number of deemed-owned ESOP shares of the S corporation; and

(B) The synthetic equity shares of the S corporation owned by such person and the members of such person's family.

(2) *Treatment of family members; definition*—(i) *Rule*. Each member of the family of any person who is a disqualified person under paragraph (d)(1)(iii) or (iv) of this section and who owns any deemed-owned ESOP shares or synthetic equity shares is a disqualified person.

(ii) *General definition*. For purposes of section 409(p) and this section, *member of the family* means, with respect to an individual—

(A) The spouse of the individual;

(B) An ancestor or lineal descendant of the individual or the individual's spouse;

(C) A brother or sister of the individual or of the individual's spouse and any lineal descendant of the brother or sister; and

(D) The spouse of any individual described in paragraph (d)(2)(ii)(B) or (C) of this section.

(iii) *Spouse*. A spouse of an individual who is legally separated from such individual under a decree of divorce or separate maintenance is not treated as such individual's spouse under paragraph (d)(2)(ii) of this section.

(3) *Special rule for certain nonallocation years*. See paragraph (c)(3) of this section (relating to avoidance or evasion of section 409(p)) for special rules under which certain persons are treated as disqualified persons.

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

Example 1. (i) *Facts*. An S corporation has 800 outstanding shares, of which 100 are owned by individual O and 700 are held in an employee stock ownership plan (ESOP) during 2006, including 200 shares held in the ESOP account of O, 65 shares held in the ESOP account of participant P, 65 shares held in the ESOP account of participant Q who is P's spouse, and 14 shares held in the ESOP account of R, who is the daughter of P and Q. There are no unallocated suspense account shares in the ESOP. The S corporation has no synthetic equity.

(ii) *Conclusion*. Under paragraph (d)(1)(i) of this section, O is a disqualified person during 2006 because O's account in the ESOP holds at least 10% of the shares owned by the ESOP (200 is 28.6% of 700). During 2006, neither P, Q, nor R is a disqualified person under paragraph (d)(1)(i) of this section, because each of their accounts holds less than 10% of the shares owned by the ESOP. However, each of P, Q, and R is a disqualified person under paragraph (d)(1)(iii) of this section because P and members of P's family own at least 20% of the deemed-owned ESOP shares (144 (the sum of 65, 65 and 14) is 20.6% of 700). As a result, disqualified persons own at least 50% of the outstanding shares of the S corporation during 2006 (O's 100 directly owned shares, O's 200 deemed-owned shares, P's 65 deemed-owned shares, Q's 65 deemed-owned shares, and R's 14 deemed-owned shares are 55.5% of 800).

Example 2. (i) *Facts*. An S corporation has shares that are owned by an ESOP and various individuals. Individuals S and T are married and have a son, U. Individuals V and W are married and have a daughter, X. Individuals U and X are married. Individual V has a brother Y. Their percentages of the deemed-owned ESOP shares of the S corporation are as follows: T has 6%; U has 7%; and V has 8%. Neither S, W, X, nor Y has any deemed-owned ESOP shares and the S corporation has no synthetic equity. However, individual S and individual Y each own directly a number of shares of the outstanding shares of the S corporation.

(ii) *Conclusion*. In this example, individual U is a disqualified person under paragraph (d)(1) of this section (because U's family consists of S, T, U, V, W, and X, and, in the aggregate, those persons own more than 20% of the deemed-owned ESOP shares) and individual X is also a disqualified person under paragraph (d)(1) of this section (because X's family consists of S, T, U, V, W, and X, and, in the aggregate, those persons own more than 20% of the deemed-owned ESOP shares). Further, individuals T and V are each a disqualified person under paragraph (d)(2) of this section because each is a member of a family that includes one or more disqualified persons and each has deemed-owned ESOP shares. However, individuals S, W, and Y are not disqualified persons under this paragraph (d). For example, S does not own more than 10% of the deemed-owned ESOP shares, and S's family, which consists of S, T, U, and X, owns, in the aggregate, only 13% of the deemed-owned ESOP shares (X's parents are not members of S's family because the family members of a person do not include the parents-in-law of the person's descendants). Further, note that, for purposes of determining whether the ESOP has a nonallocation year under paragraph (c) of this section, the shares directly owned by S and Y would be taken into account as shares owned by disqualified persons under the attribution rules in paragraph (c)(2) of this section.

(e) *Deemed-owned ESOP shares*. For purposes of section 409(p) and this section, a person is treated as owning his or her deemed-owned ESOP shares. Deemed-owned ESOP shares owned by a person mean, with respect to any person—

(1) Any shares of stock in the S corporation constituting employer securities that are allocated to such person's account under the ESOP; and

(2) Such person's share of the stock in the S corporation that is held by the ESOP but is not allocated to the account of any participant or beneficiary (with such person's share to be determined in the same proportion as the shares released and allocated from a suspense account, as described at §54.4975–11(c) and (d) of the Excise Tax Regulations, under the ESOP for the most recently ended plan year for which there were shares released and allocated from a suspense account, or if there has been no such prior release and allocation from a suspense account, then determined in proportion to a reasonable estimate of the shares that would be released and allocated in the first year of a loan repayment).

(f) *Synthetic equity and rights to acquire stock of the S corporation*—(1) *Ownership of synthetic equity*. For purposes of section 409(p) and this section, synthetic equity means the rights described in paragraph (f)(2) of this section. Synthetic equity is treated as owned by the person that has any of the rights specified in paragraph (f)(2) of the section. In addition, the attribution rules as set forth in paragraph (c)(2) of this section apply for purposes of attributing ownership of synthetic equity.

(2) *Synthetic equity*—(i) *Rights to acquire stock of the S corporation*—(A) *General rule*. Synthetic equity includes any stock option, warrant, restricted stock, deferred issuance stock right, stock appreciation right payable in stock, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Rights to acquire stock in an S corporation with respect to stock that is, at all times during the period when such rights are effective, both issued and outstanding, and held by a person other than the ESOP, the S corporation, or a related entity are not synthetic equity but only if that person is subject to federal income taxes. (See also paragraph (c)(4) of this section.)

(B) *Exception for certain rights of first refusal*. A right of first refusal to acquire stock held by an ESOP is not treated as a right to acquire stock of an S corporation under this paragraph if the right to acquire stock would not be taken into account under §1.1361–1(l)(2)(iii)(A) in determining if an S corporation has a second class of stock and the price at which the stock is acquired under the right of first refusal is not less than the price determined under section 409(h). See §54.4975–11(d)(5) of the Excise Tax Regulations. The right of first refusal must also comply with the requirements of §54.4975–7(b)(9) of the Excise Tax Regulations. This paragraph (f)(2)(i)(B) does not apply if, based on the facts and circumstances, the Commissioner finds that the right to acquire stock held by the ESOP constitutes an avoidance or an evasion of section 409(p). See also section 408(d) of ERISA, under which the exemption provided by section 408(e) of ERISA (and the related exemption at section 4975(d)(13) of the Code) does not apply to an owner-employee, including an employee or officer of an S corporation who is a 5 percent owner.

(ii) *Special rule for certain stock rights*. Synthetic equity also includes a right to a future payment (payable in cash or any other form other than stock of the S corporation) from an S corporation that is based on the value of the stock of the S corporation, such as appreciation in such value. Thus, for example, synthetic equity includes a stock appreciation right with respect to stock of an S corporation that is payable in cash or a phantom stock unit with respect to stock of an S corporation that is payable in cash.

(iii) *Rights to acquire interests in or assets of an S corporation or a related entity*. Synthetic equity includes a right to acquire stock or other similar interests in a related entity to the extent of the S corporation's ownership. Synthetic equity also includes a right to acquire assets of an S corporation or a related entity other than either rights to acquire goods, services, or property at fair market value in the ordinary course of business or fringe benefits excluded from gross income under section 132.

(iv) *Special rule for nonqualified deferred compensation*. (A) Synthetic equity also includes any of the following with respect to an S corporation or a related entity: any remuneration to which section 404(a)(5) applies; remuneration for which a deduction would be permitted under section 404(a)(5) if separate accounts were maintained; any right to receive property, as defined in §1.83–3(e) of the Income Tax Regulations (including a payment to a trust described in section 402(b) or to an annuity described in section 403(c)) in a future year for the performance of services; any transfer of property in connection with the performance of services to which section 83 applies to the extent that the property is not substantially vested within the meaning of §1.83–3(i) by the end of the plan year in which transferred; and a split-dollar life insurance arrangement under §1.61–22(b) entered into in connection with the performance of services (other than one under which, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in §1.61–22(d)(3)). Synthetic equity also includes any other remuneration for services under a plan, method, or arrangement deferring the receipt of compensation to a date that is after the 15th day of the 3rd calendar month after the end of the entity's taxable year in which the related services are rendered. However, synthetic equity does not include benefits under a plan that is an eligible retirement plan within the meaning of section 402(c)(8)(B).

(B) For purposes of applying paragraph (f)(2)(iv)(A) of this section with respect to an ESOP, synthetic equity does not include any interest described in such paragraph (f)(2)(iv)(A) of this section to the extent that—

(*1*) The interest is nonqualified deferred compensation (within the meaning of section 3121(v)(2)) that was outstanding on December 17, 2004;

(*2*) The interest is an amount that was taken into account (within the meaning of §31.3121(v)(2)–1(d) of this chapter) prior to January 1, 2005, for purposes of taxation under chapter 21 of the Internal Revenue Code (or income attributable thereto); and

(*3*) The interest was held before the first date on which the ESOP acquires any employer securities.

(v) *No overlap among shares of deemed-owned ESOP shares or synthetic equity*. Synthetic equity under this paragraph (f)(2) does not include shares that are deemed-owned ESOP shares (or any rights with respect to deemed-owned ESOP shares to the extent such rights are specifically provided under section 409(h)). In addition, synthetic equity under a specific subparagraph of this paragraph (f)(2) does not include anything that is synthetic equity under a preceding provision of paragraph (f)(2)(i), (ii), (iii), or (iv) of this section.

(3) *Related entity*. For purposes of this paragraph (f), *related entity* means any en-

tity in which the S corporation holds an interest and which is a partnership, a trust, an eligible entity that is disregarded as an entity that is separate from its owner under §301.7701–3 of this chapter, or a qualified subchapter S subsidiary under section 1361(b)(3).

(4) *Number of synthetic shares*—(i) *Synthetic equity determined by reference to S corporation shares*. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, the person who is entitled to the synthetic equity is treated as owning the number of shares of stock deliverable pursuant to such synthetic equity. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, but for which payment is made in cash or other property (besides stock of the S corporation), the number of shares of synthetic equity treated as owned is equal to the number of shares of stock having a fair market value equal to the cash or other property (disregarding lapse restrictions as described in §1.83–3(i)). Where such synthetic equity is a right to purchase or receive S corporation shares, the corresponding number of shares of synthetic equity is determined without regard to lapse restrictions as described in §1.83–3(i) or to any amount required to be paid in exchange for the shares. Thus, for example, if a corporation grants an employee of an S corporation an option to purchase 100 shares of the corporation's stock, exercisable in the future only after the satisfaction of certain performance conditions, the employee is the deemed owner of 100 synthetic equity shares of the corporation as of the date the option is granted. If the same employee were granted 100 shares of restricted S corporation stock (or restricted stock units), subject to forfeiture until the satisfaction of performance or service conditions, the employee would likewise be the deemed owner of 100 synthetic equity shares from the grant date. However, if the same employee were granted a stock appreciation right with regard to 100 shares of S corporation stock (whether payable in stock or in cash), the number of synthetic equity shares the employee is deemed to own equals the number of shares having a value equal to the appreciation at the time of measurement (determined without regard to lapse restrictions).

(ii) *Synthetic equity determined by reference to shares in a related entity*. In the case of synthetic equity that is determined by reference to shares of stock (or similar interests) in a related entity, the person who is entitled to the synthetic equity is treated as owning shares of stock of the S corporation with the same aggregate value as the number of shares of stock (or similar interests) of the related entity (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)).

(iii) *Other synthetic equity*—(A) *General rule*. In the case of any synthetic equity to which neither paragraph (f)(4)(i) of this section nor paragraph (f)(4)(ii) of this section apply, the person who is entitled to the synthetic equity is treated as owning on any date a number of shares of stock in the S corporation equal to the present value (on that date) of the synthetic equity (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)) divided by the fair market value of a share of the S corporation's stock as of that date.

(B) *Use of annual or more frequent determination dates*. A year is a nonallocation year if the thresholds in paragraph (c) of this section are met at any time during that year. However, for purposes of this paragraph (f)(4)(iii), an ESOP may provide that the number of shares of S corporation stock treated as owned by a person who is entitled to synthetic equity to which this paragraph (f)(4)(iii) applies is determined annually (or more frequently), as of the first day of the ESOP's plan year or as of any other reasonable determination date or dates during a plan year. If the ESOP so provides, the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies that are treated as owned by that person for any period from a given determination date through the date immediately preceding the next following determination date is the number of shares treated as owned on the given determination date.

(C) *Use of triennial recalculations*. (*1*) Although an ESOP must have a determination date that is no less frequent than annually, if the terms of the ESOP so provide, then the number of shares of synthetic equity with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies may be fixed for a specified period from a determination date identified under the ESOP through the day before a determination date that is not later than the third anniversary of the identified determination date. Thus, the ESOP must provide for the number of shares of synthetic equity to which this paragraph (f)(4)(iii) applies to be re-determined not less frequently than every three years, based on the S corporation share value on a determination date that is not later than the third anniversary of the identified determination date and the aggregate present value of the synthetic equity to which this paragraph (f)(4)(iii) applies (including all grants made during the three-year period) on that determination date.

(*2*) However, additional accruals, allocations, or grants (to which this paragraph (f)(4)(iii) applies) that are made during such three-year period are taken into account on each determination date during that period, based on the number of synthetic equity shares resulting from the additional accrual, allocation, or grant (determined as of the determination date on or next following the date of the accrual, allocation, or grant). See *Example 3* of paragraph (h) of this section for an example illustrating this paragraph (f)(4)(iii)(C).

(*3*) If, as permitted under this paragraph (f)(4)(iii)(C), an ESOP provides for the number of shares of synthetic equity to be fixed for a specified period from a determination date to a subsequent determination date, then that subsequent determination date can be changed to a new determination date, subject to the following conditions:

(*i*) The change in the subsequent determination date must be effectuated through a plan amendment adopted before the new determination date;

(*ii*) The new determination date must be earlier than the prior determination date (that is, the new determination date must be earlier than the determination date applicable in the absence of the plan amendment);

(*iii*) The conditions in paragraph (f)(4)(iii)(C)(*2*) of this section must be satisfied measured from the new determination date; and

(*iv*) Except to the extent permitted by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter), the change must be adopted in connection with either a change in the plan year of the ESOP or a merger, consolidation, or transfer of plan assets of the ESOP under section 414(l) (and the new determination date must be consistent with that plan year change or section 414(l) event).

(*4*) *Conditions for application of rules*. This paragraph (f)(4)(iii)(C) only applies with respect to grants of synthetic equity to which this paragraph (f)(4)(iii) applies. In addition, paragraph (f)(4)(iii)(C) of this section applies only if the fair market value of a share of the S corporation securities on any determination date is not unrepresentative of the value of the S corporation securities throughout the rest of the plan year and only if the terms of the ESOP include provisions conforming to paragraph (f)(4)(iii)(C)(*1*) of this section which are consistently used by the ESOP for all persons. In addition, paragraph (f)(4)(iii)(C)(*1*) of this section applies only if the terms of the ESOP include provisions conforming to paragraphs (f)(4)(iii)(C)(*1*) of this section which are consistently used by the ESOP for all persons.

(iv) *Adjustment of number of synthetic equity shares where ESOP owns less than 100 Percent of S corporation*. The number of synthetic shares otherwise determined under this paragraph (f)(4) is decreased ratably to the extent that shares of the S corporation are owned by a person who is not an ESOP and who is subject to Federal income taxes. For example, if an S corporation has 200 outstanding shares, of which individual A owns 50 shares and the ESOP owns the other 150 shares, and individual B would be treated under this paragraph (f)(4) as owning 100 synthetic equity shares of the S corporation but for this paragraph (f)(4)(iv), then, under the rule of this paragraph (f)(4)(iv), the number of synthetic shares treated as owned by B under this paragraph (f)(4) is decreased from 100 to 75 (because the ESOP only owns 75 percent of the outstanding stock of the S corporation, rather than 100 percent).

(v) *Special rule for shares with greater voting power than ESOP shares*. Notwithstanding any other provision of this paragraph (f)(4), if a synthetic equity right includes (directly or indirectly) a right to purchase or receive shares of S corporation stock that have per-share voting rights greater than the per-share voting rights of one or more shares of S corporation stock held by the ESOP, then the number of shares of deemed owned synthetic equity attributable to such right is not less than the number of shares that would have the same voting rights if the shares had the same per-share voting rights as shares held by the ESOP with the least voting rights. For example, if shares of S corporation stock held by the ESOP have one voting right per share, then an individual who holds an option to purchase one share with 100 voting rights is treated as owning 100 shares of synthetic equity.

(g) *Avoidance or evasion of section 409(p) involving synthetic equity*—(1) *General rule*. Paragraph (g)(2) of this section sets forth a standard for determining whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p). Paragraph (g)(3) of this section identifies certain specific ownership structures that constitute an avoidance or evasion of section 409(p). See also paragraph (c)(3) of this section for a rule under which the ownership structures in paragraph (g)(3) of this section result in a nonallocation year for purposes of section 409(p).

(2) *Standard for determining when there is an avoidance or evasion of section 409(p) involving synthetic equity*. For purposes of section 409(p) and this section, whether the principal purpose of the ownership structure of an S corporation involving synthetic equity constitutes an avoidance or evasion of section 409(p) is determined by taking into account all the surrounding facts and circumstances, including all features of the ownership of the S corporation's outstanding stock and related obligations (including synthetic equity), any shareholders who are taxable entities, and the cash distributions made to shareholders, to determine whether, to the extent of the ESOP's stock ownership, the ESOP receives the economic benefits of ownership in the S corporation that occur during the period that stock of the S corporation is owned by the ESOP. Among the factors indicating that the ESOP receives those economic benefits include shareholder voting rights, the right to receive distributions made to shareholders, and the right to benefit from the profits earned by the S corporation, including the extent to which actual distributions of profits are made from the S corporation to the ESOP and the extent to which the ESOP's ownership interest in undistributed profits and future profits is subject to dilution as a result of synthetic equity. For example, the ESOP's ownership interest is not subject to dilution if the total amount of synthetic equity is a relatively small portion of the total number of shares and deemed-owned shares of the S corporation.

(3) *Specific transactions that constitute an avoidance or evasion of section 409(p) involving segregated profits*. Taking into account the standard in paragraph (g)(2) of this section, the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p) in any case in which—

(i) The profits of the S corporation generated by the business activities of a specific individual or individuals are not provided to the ESOP, but are instead substantially accumulated and held for the benefit of the individual or individuals on a tax-deferred basis within an entity related to the S corporation, such as a partnership, trust, or corporation (such as in a subsidiary that is a disregarded entity), or any other method that has the same effect of segregating profits for the benefit of such individual or individuals (such as nonqualified deferred compensation described in paragraph (f)(2)(iv) of this section);

(ii) The individual or individuals for whom profits are segregated have rights to acquire 50 percent or more of those profits directly or indirectly (for example, by purchase of the subsidiary); and

(iii) A nonallocation year would occur if this section were separately applied with respect to either the separate entity or whatever method has the effect of segregating profits of the individual or individuals, treating such entity as a separate S corporation owned by an ESOP (or in the case of any other method of segregation of profits by treating those profits as the only assets of a separate S corporation owned by an ESOP).

(h) *Examples*. The rules of this section are illustrated by the following examples:

Example 1. Relating to determination of disqualified persons and nonallocation year if there is no synthetic equity. (i) *Facts*. Corporation X is a calendar year S corporation that maintains an ESOP. X has a single class of common stock, of which there are a total of 1,200 shares outstanding. X has no synthetic equity. In 2006, individual A, who is not an employee of X (and is not related to any employee of X), owns 100 shares directly, B, who is an employee of *X*, owns 100 shares directly, and the remaining 1,000 shares are owned by an ESOP maintained by X for its employees. The ESOP's 1,000 shares are allocated to the accounts of individuals who are employees of X (none of whom are related), as set forth in columns 1 and 2 in the following table:

1 Shareholders	2 Deemed-Owned ESOP Shares (total of 1,000)	3 Percentage Deemed-Owned ESOP Shares	4 Disqualified Person
B	330	33%	Yes
C	145	14.5%	Yes
D	75	7.5%	No
E	30	3%	No
F	20	2%	No
Other participants	400 (none exceed 10 shares)	1% or less	No

(ii) *Conclusion with respect to disqualified persons*. As shown in column 4 in the table contained in paragraph (i) of *Example 1*, individuals B and C are disqualified persons for 2006 under paragraph (d)(1) of this section because each owns at least 10% of X's deemed-owned ESOP shares. However, the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares.

(iii) *Conclusion with respect to nonallocation year*. 2006 is not a nonallocation year under section 409(p) because disqualified persons do not own at least 50% of X's outstanding shares (the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, plus C's 145 deemed-owned ESOP shares equal only 47.9% of the 1,200 outstanding shares of X).

Example 2. Relating to determination of disqualified persons and nonallocation year if there is synthetic equity. (i) *Facts*. The facts are the same as in *Example 1*, except that, as shown in column 4 of the table in this *Example 2*, individuals E and F have options to acquire 110 and 130 shares, respectively, of the common stock of X from X:

1 Shareholder	2 Deemed-Owned ESOP Shares (total of 1,000)	3 Percentage Deemed-Owned ESOP Shares	4 Options (240)	5 Shareholder Percentage of Deemed-Owned ESOP plus Synthetic Equity Shares	6 Disqualified Person
B	330	33%			Yes (col. 3)
C	145	14.5%			Yes (col. 3)
D	75	7.5%			No
E	30	3%	110	11.1% ([30+ 91.7] divided by 1,091.7)	Yes (col. 5)
F	20	2%	130	11.6% ([20 +108.3] divided by 1,108.3)	Yes (col. 5)
Other participants	400 (none exceeds 10 shares)	1% or less			No

(ii) *Conclusion with respect to disqualified persons*. Individual E's synthetic equity shares are counted in determining whether E is a disqualified person for 2006, and individual F's synthetic equity shares are counted in determining whether F is a disqualified person for 2006. Applying the rule of paragraph (f)(4)(iv) of this section, E's option to acquire 110 shares of the S corporation converts under paragraph (f)(4)(iv) of this section, into 91.7 shares of synthetic equity (110 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). Similarly, F's option to acquire 130 shares of the S corporation converts into 108.3 shares of synthetic equity (130 times the ratio of the 1,000 deemed-owned ESOP shares to the sum of the 1,000 deemed-owned ESOP shares plus the 200 shares held outside the ESOP by A and B). However, the synthetic equity shares owned by any person do not affect the calculation for any other person's ownership of shares. Accordingly, as shown in column 6 in the table contained in paragraph (i) of *Example 2*, individuals B, C, E, and F are disqualified persons for 2006.

(iii) *Conclusion with respect to nonallocation year*. The 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, E's 91.7 synthetic equity shares, F's 20 deemed-owned ESOP shares, plus F's 108.3 synthetic equity shares total 825, which equals 58.9% of 1,400, which is the sum of the 1,200 outstanding shares of X and the 200 shares of synthetic equity shares of X held by disqualified persons. Thus, 2006 is a nonallocation year for X's ESOP under section 409(p) because disqualified persons own at least 50% of the total shares of outstanding stock of X and the total synthetic equity shares of X held by disqualified persons. In addition, independent of the preceding conclusion, 2006 would be a nonallocation year because disqualified persons own at least 50% of X's outstanding shares because the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, plus F's 20 deemed-owned ESOP shares equal 52.1% of the 1,200 outstanding shares of X.

Example 3. Relating to determination of number of shares of synthetic equity. (i) *Facts*. Corporation Y is a calendar year S corporation that maintains an ESOP. Y has a single class of common stock, of which there are a total of 1,000 shares outstanding, all of which are owned by the ESOP. Y has no synthetic equity, except for four grants of nonqualified deferred compensation that are made to an individual during the period from 2005 through 2011, as set forth in column 2 in the following table. The ESOP provides for the rules in paragraph (f)(4)(iii) of this section to determine the number of shares of synthetic equity owned by that individual with a determination date of January 1 and the triennial rule redetermining value, as shown in columns 4 and 5:

1 Determination Date	2 Present Value of Nonqualified Deferred Compensation on Determination Date	3 Share Value on Determination Date	4 New Shares of Synthetic Equity on Determination Date	5 Aggregate Number of Synthetic Equity Shares on Determination Date
January 1, 2005	A grant is made on January 1, 2005, with a present value of $1,000. An additional grant of nonqualified deferred compensation with a present value of $775 is made on March 1, 2005.	$10 per share	100	100
January 1, 2006	An additional grant is made on December 31, 2005, which has a present value of $800 on January 1, 2006. The March 1, 2005, grant has a present value on January 1, 2006, of $800.	$8 per share	200	300
January 1, 2007	No new grants made.	$12 per share		300
January 1, 2008	An additional grant is made on December 31, 2007, which has a present value of $3,000 on January 1, 2008. The grants made during 2005 through 2007 have an aggregate present value on January 1, 2008, of $3,750.	$15 per share	200	450
January 1, 2009	No new grants are made.	$11 per share		450
January 1, 2010	No new grants are made.	$22 per share		450
January 1, 2011	No new grants are made. The grants made during 2005 through 2008 have an aggregate present value on January 1, 2011, of $7,600.	$20 per share		380

(ii) *Conclusion*. The grant made on January 1, 2005, is treated as 100 shares until the determination date in 2008. The grant made on March 1, 2005, is not taken into account until the 2006 determination date and its present value on that date, along with the then present value of the grant made on December 31, 2005, is treated as a number of shares that are based on the $8 per share value on the 2006 determination date, with the resulting number of shares continuing to apply until the determination date in 2008. On the January 1, 2008, determination date, the grant made on the preceding day is taken into account at its present value of $3,000 on January 1, 2008 and the $15 per share value on that date with the resulting number of shares (200) continuing to apply until the next determination date. In addition, on the January 1, 2008, determination date, the number of shares determined under other grants made between January 1, 2005 and December 31, 2007, must be revalued. Accordingly, the aggregate value of all nonqualified deferred compensation granted during that period is determined to be $3750 on January 1, 2008, and the corresponding number of shares of synthetic equity based on the $15 per share value is determined to be 250 shares on the 2008 determination date, with the resulting aggregate number of shares (450) continuing to apply until the determination date in 2011. On the January 1, 2011, determination date, the aggregate value of all nonqualified deferred compensation is determined to be $7,600 and the corresponding number of shares of synthetic equity based on the $20 per share value on the 2011 determination date is determined to be 380 shares (with the resulting number of shares continuing to apply until the day before the determination date in 2014, assuming no further grants are made).

(i) *Effective dates*—(1) *Statutory effective date*. (i) Except as otherwise provided in paragraph (i)(1)(ii) of this section, section 409(p) applies for plan years ending after March 14, 2001.

(ii) If an ESOP holding stock in an S corporation was established on or before March 14, 2001, and the election under section 1362(a) with respect to that S corporation was in effect on March 14, 2001, section 409(p) applies for plan years beginning on or after January 1, 2005.

(2) *Regulatory effective date*. This section applies for plan years beginning on or after January 1, 2006. For plan years beginning before January 1, 2006, §1.409(p)–1T (as it appeared in the April 1, 2005, edition of 26 CFR part 1) applies.

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

Approved November 30, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 19, 2006, 8:45 a.m., and published in the issue of the Federal Register for December 20, 2006, 71 F.R. 76134)

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

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

LIFO; price indexes; department stores. The November 2006 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, November 30, 2006.

Rev. Rul. 2007–6

The following Department Store Inventory Price Indexes for November 2006 were issued by the Bureau of Labor Statistics (BLS). The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, November 30, 2006.

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

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

Groups	Nov. 2005	Nov. 2006	Percent Change from Nov. 2005 to Nov. 2006[1]
1. Piece Goods	480.6	471.2	-2.0
2. Domestics and Draperies	508.2	478.1	-5.9
3. Women's and Children's Shoes	684.7	678.1	-1.0
4. Men's Shoes	868.9	894.2	2.9
5. Infants' Wear	564.1	573.3	1.6
6. Women's Underwear	548.8	560.2	2.1
7. Women's Hosiery	339.8	346.5	2.0
8. Women's and Girls' Accessories	582.1	542.0	-6.9
9. Women's Outerwear and Girls' Wear	368.3	373.5	1.4
10. Men's Clothing	542.1	529.6	-2.3
11. Men's Furnishings	574.9	574.9	0.0
12. Boys' Clothing and Furnishings	403.5	411.3	1.9
13. Jewelry	861.4	893.3	3.7
14. Notions	803.1	817.9	1.8
15. Toilet Articles and Drugs	1001.0	1005.1	0.4
16. Furniture and Bedding	596.7	596.9	0.0
17. Floor Coverings	612.3	623.2	1.8
18. Housewares	701.9	689.7	-1.7
19. Major Appliances	204.3	208.9	2.3
20. Radio and Television	38.1	34.4	-9.7
21. Recreation and Education[2]	77.6	76.7	-1.2
22. Home Improvements[2]	137.2	141.3	3.0
23. Automotive Accessories[2]	116.5	122.2	4.9
Groups 1–15: Soft Goods	561.0	561.9	0.2
Groups 16–20: Durable Goods	376.2	371.2	-1.3
Groups 21–23: Misc. Goods[2]	93.1	94.2	1.2
Store Total[3]	495.4	495.3	0.0

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

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

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

DRAFTING INFORMATION

The principal author of this revenue ruling is John Roman Faron of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Faron at (202) 622–8142 (not a toll-free call).

Part III. Administrative, Procedural, and Miscellaneous

Miscellaneous Pension Protection Act Changes

Notice 2007–7

I. PURPOSE

This notice provides guidance in the form of questions and answers with respect to certain provisions of the Pension Protection Act of 2006, P.L. 109–280 ("PPA '06"), that are effective in 2007 or earlier. The sections of PPA '06 addressed in this notice, which are primarily related to distributions, are § 303 (relating to interest rate assumptions for lump sum distributions), § 826 (relating to hardship distributions), § 828 (relating to early distributions to public safety employees), § 829 (relating to rollovers for nonspouse beneficiaries), § 845 (relating to distributions to pay for accident or health insurance for public safety officers), § 904 (relating to vesting of nonelective contributions), § 1102 (relating to the notice and consent period for distributions), and § 1201 (relating to distributions from IRAs to charitable organizations).

II. SECTION 303 OF PPA '06

Section 415(b) of the Code provides limitations on annual benefits under a defined benefit plan. Under § 415(b)(2)(B), if a benefit is payable in a form other than a straight life annuity, the benefit is adjusted to an actuarially equivalent straight life annuity for purposes of determining whether the limitations of § 415(b) have been satisfied. Section 415(b)(2)(E) provides limitations on the actuarial assumptions that can be used in making the adjustment under § 415(b)(2)(B). Prior to the enactment of PPA '06, for purposes of adjusting a benefit payable in a form that is subject to the minimum present value requirements of § 417(e)(3), § 415(b)(2)(E)(ii) provided that the interest rate assumption must not be less than the greater of the applicable interest rate as defined in § 417(e)(3) or the rate specified in the plan. However, § 101(b)(4) of the Pension Funding Equity Act of 2004, P.L. 108–218, amended § 415(b)(2)(E)(ii) to provide that, for plan years beginning in 2004 and 2005, 5.5% must be used in lieu of the applicable interest rate (as defined in § 417(e)(3)) for purposes of adjusting the benefit.

Section 303(a) of PPA '06 amended § 415(b)(2)(E)(ii) to provide that the interest rate assumption for purposes of adjusting a benefit payable in a form that is subject to the minimum present value requirements of § 417(e)(3) must not be less than the greatest of (i) 5.5%, (ii) the rate that provides a benefit of not more than 105% of the benefit that would be provided if the applicable interest rate (as defined in § 417(e)(3)) were the interest rate assumption, or (iii) the rate specified under the plan.

Q–1. What is the effective date of the changes made to § 415 of the Code by § 303(a) of PPA '06?

A–1. The changes to § 415 of the Code made by § 303(a) of PPA '06 apply to distributions made in plan years beginning after December 31, 2005. However, the changes do not apply to a plan with a termination date that is on or before August 17, 2006, the date of enactment of PPA '06.

Q–2. May a plan be amended retroactively to comply with the requirements of § 303(a) of PPA '06 without violating the anti-cutback rules provided in § 411(d)(6) of the Code?

A–2. Yes. Under § 1107 of PPA '06, a plan does not violate the anti-cutback rules of § 411(d)(6) of the Code if it is amended retroactively to comply with § 303(a) of PPA '06, provided the amendment is adopted on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of a governmental plan), and the plan is operated as if such amendment were in effect as of the first date the amendment is effective.

Q–3. If a plan made a distribution in a plan year beginning in 2006 that satisfied the limitations of § 415(b) prior to the enactment of PPA '06 but which is in excess of the limitations of § 415(b) taking into account the amendments to § 415 made by § 303(a) of PPA '06 (a "§ 303 excess distribution"), does the distribution violate the requirements of § 415(b)?

A–3. Yes. However, three methods are available for correcting a § 303 excess distribution. First, Q&A–4 of this notice sets forth a special correction method that is available for a § 303 excess distribution made prior to September 1, 2006, provided that the correction is completed by March 15, 2007. Second, if correction is completed by December 31, 2007 (even if the § 303 excess distribution occurs after September 1, 2006), a plan may correct a § 303 excess distribution by using the correction method for a § 415(b) excess distribution described in the Employee Plans Compliance Resolution System ("EPCRS") (see section 2.04(1) in Appendix B in Rev. Proc. 2006–27, 2006–22 I.R.B. 945) even if the plan does not meet the requirements specified in Rev. Proc. 2006–27, including the special requirements for self correction under Part IV of Rev. Proc. 2006–27. Finally, a plan that meets the requirements of Rev. Proc. 2006–27 may correct § 303 excess distributions by using the correction method for § 415(b) excess distributions under EPCRS even after December 31, 2007. A plan that is amended retroactively to comply with § 303(a) of PPA '06 will not fail to satisfy the requirement in § 1107(b)(2)(A) of PPA '06 (that the plan be operated in accordance with the terms of the amendment) merely because it made a § 303 excess distribution, provided the § 303 excess distribution is corrected using one of these three correction methods.

Q–4. What special correction method is available to correct a § 303 excess distribution made prior to September 1, 2006?

A–4. A special correction method is available for a § 303 excess distribution made prior to September 1, 2006, provided the correction is completed by March 15, 2007. Under the special correction method, a plan may use the EPCRS correction method for a § 415(b) excess distribution (as described in section 2.04(1) in Appendix B in Rev. Proc. 2006–27, even if the plan does not otherwise meet the requirements of Rev. Proc. 2006–27, including the special requirements for self correction) with the following modifications. The excess amount (*i.e.*, the amount by which the distribution actually made exceeds the distribution permitted using the interest assumption specified in § 415(b) as amended by PPA '06) is not required to be returned to the plan (as otherwise required under the EPCRS correction method). Instead, a plan must issue two Forms 1099–R (*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs*, Insurance Contracts, etc.) to a participant who has received a § 303 excess distribution. The first Form 1099–R should include only the amount that would have been distributed had the benefit payable been adjusted using the interest assumptions specified in § 415(b) as amended by PPA '06. The second Form 1099–R should include only the excess amount that was distributed, and should include code "E" in box 7 to identify the amount as an excess distribution. As provided in the EPCRS correction, this excess amount is not an eligible rollover distribution, and therefore must be included in gross income in the year distributed from the plan.

III. SECTION 826 OF PPA '06

An employee's elective contributions under a cash or deferred arrangement can only be distributed upon the occurrence of certain events, one of which is the employee's hardship. A distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. A distribution made for any of the expenses listed in Regulation § 1.401(k)–1(d)(3)(iii)(B) is deemed to be on account of an immediate and heavy financial need of the employee. Several of these listed expenses can be expenses of the employee's spouse or dependents.

Section 826 of PPA '06 directs the Secretary of the Treasury to modify the rules relating to distributions from § 401(k), § 403(b), § 409A, and § 457(b) plans on account of a participant's hardship or unforeseeable financial emergency to permit such plans to treat a participant's beneficiary under the plan the same as the participant's spouse or dependent in determining whether the participant has incurred a hardship or unforeseeable financial emergency.

Q–5. What changes are being made pursuant to § 826 of PPA '06 in the rules relating to hardship distributions from § 401(k) plans and § 403(b) plans and relating to distributions on account of an unforeseeable financial emergency from a plan described in § 457(b) or § 409A?

A–5. (a) *Hardship distributions from § 401(k) plans and § 403(b) plans*. A § 401(k) plan that permits hardship distributions of elective contributions to a participant only for expenses described in § 1.401(k)–1(d)(3)(iii)(B) may, beginning August 17, 2006, permit distributions for expenses described in § 1.401(k)–1(d)(3)(iii)(B)(*1*), (*3*), or (*5*) (relating to medical, tuition, and funeral expenses, respectively) for a primary beneficiary under the plan. For this purpose, a "primary beneficiary under the plan" is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant's account balance under the plan upon the death of the participant. A plan that adopts these expanded hardship provisions must still satisfy all the other requirements applicable to hardship distributions, such as the requirement that the distribution be necessary to satisfy the financial need. These rules also apply to § 403(b) plans.

(b) *Distributions on account of an unforeseeable financial emergency from a plan described in § 457(b) or § 409A*. In applying § 457(d)(1)(A)(iii), § 1.457–6(c)(2)(i), § 409A(a)(2)(A)(vi), and Proposed Regulation § 1.409A–3(g)(3)(i), a plan described in § 457(b) or § 409A may treat a participant's beneficiary under the plan the same as the participant's spouse or dependent in determining whether the participant has incurred an unforeseeable financial emergency. This will be reflected in the upcoming final regulations under § 409A.

IV. SECTION 828 OF PPA '06

Section 72(t)(1) of the Code provides for a 10% additional tax on an early distribution from a qualified retirement plan (as defined in § 4974(c)), unless the early distribution qualifies for one of the exceptions listed in § 72(t)(2). For example, § 72(t)(2)(A)(v) provides an exception to the 10% additional tax for distributions made to an employee who separates from service after attainment of age 55. Under § 72(t)(3)(A), § 72(t)(2)(A)(v) does not apply to individual retirement plans.

Section 828 of PPA '06 amended § 72 of the Code by adding § 72(t)(10), which provides that in the case of a distribution to a qualified public safety employee from a governmental defined benefit plan, § 72(t)(2)(A)(v) is applied by substituting age 50 for age 55. Thus, the 10% additional tax on early distributions under § 72(t)(1) does not apply to a distribution from a governmental defined benefit plan made to a qualified public safety employee who separates from service after attainment of age 50. This exception to the 10% additional tax applies to distributions made after August 17, 2006 (the date of enactment of PPA '06).

Q–6. Who is a qualified public safety employee?

A–6. For purposes of § 72(t)(10), the term "qualified public safety employee" means an employee of a State or of a political subdivision of a State (such as a county or city) whose principal duties include services requiring specialized training in the area of police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the State or the political subdivision of the State.

Q–7. How does a qualified public safety employee qualify for the exception to the 10% additional tax under § 72(t)(10)?

A–7. In order to qualify for the exception to the 10% additional tax under § 72(t)(10), a qualified public safety employee (i) must have received the distribution from a governmental defined benefit plan after separating from service with the employer maintaining the plan and (ii) the separation from service must have occurred during or after the calendar year in which the qualified public safety employee attained age 50. For example, a qualified public safety employee who separated from service on June 30, 2006, and attained age 50 on December 12, 2006, is eligible for the exception under § 72(t)(10) with respect to distributions made after August 17, 2006.

Q–8. What are the consequences if, before August 18, 2006, a qualified public safety employee began receiving substantially equal periodic payments that qualify for the exception to the 10% additional tax described in § 72(t)(2)(A)(iv) and then modified the periodic payments after August 17, 2006?

A–8. If the payments satisfy the requirements in Q&A–7 of this notice, payments received by the qualified public safety employee after August 17, 2006, would qualify for the exception to the 10% additional tax under § 72(t)(10). However, if the modification would result in the imposition of the recapture tax under the rules of § 72(t)(4), then the recapture tax applies to the payments made before August 18, 2006.

Q–9. Does the exception to the 10% additional tax under § 72(t)(10) apply if the qualified public safety employee rolls over distributions from a governmental defined benefit plan into an IRA or a defined contribution plan and subsequently takes an early distribution from the IRA or defined contribution plan?

A–9. No. The exception to the 10% additional tax under § 72(t)(10) applies only to amounts distributed from a governmental defined benefit plan and does not apply to distributions from a defined contribution plan or an individual retirement plan.

Q–10. How does a payer report distributions that qualify for the exception to the 10% additional tax under § 72(t)(10) on Form 1099–R?

A–10. A payer is permitted to use distribution code 2 (early distribution, exception applies) in box 7 of Form 1099–R. However, a payer is also permitted to use distribution code 1 (early distribution, no known exception) in box 7 of Form 1099–R, if the payer does not know whether the exception under § 72(t)(10) applies. For further information on reporting, see Instructions for Forms 1099–R and 5498.

V. SECTION 829 OF PPA '06

Under § 402(c)(11) of the Code, which was added by § 829 of PPA '06, if a direct trustee-to-trustee transfer of any portion of a distribution from an eligible retirement plan is made to an individual retirement plan described in § 408(a) or (b) (an "IRA") that is established for the purpose of receiving the distribution on behalf of a designated beneficiary who is a nonspouse beneficiary, the transfer is treated as a direct rollover of an eligible rollover distribution for purposes of § 402(c). The IRA of the nonspouse beneficiary is treated as an inherited IRA within the meaning of § 408(d)(3)(C). Section 402(c)(11) applies to distributions made after December 31, 2006.

Q–11. Can a qualified plan described in § 401(a) offer a direct rollover of a distribution to a nonspouse beneficiary?

A–11. Yes. Under § 402(c)(11), a qualified plan described in § 401(a) can offer a direct rollover of a distribution to a nonspouse beneficiary who is a designated beneficiary within the meaning of § 401(a)(9)(E), provided that the distributed amount satisfies all the requirements to be an eligible rollover distribution other than the requirement that the distribution be made to the participant or the participant's spouse. (See § 1.401(a)(9)–4 for rules regarding designated beneficiaries.) The direct rollover must be made to an IRA established on behalf of the designated beneficiary that will be treated as an inherited IRA pursuant to the provisions of § 402(c)(11). If a nonspouse beneficiary elects a direct rollover, the amount directly rolled over is not includible in gross income in the year of the distribution. See § 1.401(a)(31)–1, Q&A–3 and–4, for procedures for making a direct rollover.

Q–12. Can other types of plans offer a direct rollover of a distribution to a nonspouse beneficiary?

A–12. Yes. Section 402(c)(11) also applies to annuity plans described in § 403(a) or (b) and to eligible governmental plans under § 457(b).

Q–13. How must the IRA be established and titled?

A–13. The IRA must be established in a manner that identifies it as an IRA with respect to a deceased individual and also identifies the deceased individual and the beneficiary, for example, "Tom Smith as beneficiary of John Smith."

Q–14. Is a plan required to offer a direct rollover of a distribution to a nonspouse beneficiary pursuant to § 402(c)(11)?

A–14. No. A plan is not required to offer a direct rollover of a distribution to a nonspouse beneficiary. If a plan does offer direct rollovers to nonspouse beneficiaries of some, but not all, participants, such rollovers must be offered on a nondiscriminatory basis because the opportunity to make a direct rollover is a benefit, right, or feature that is subject to § 401(a)(4). In the case of distributions from a terminated defined contribution plan pursuant to 29 C.F.R. § 2550.404a–3(d)(1)(ii), the plan will be considered to offer direct rollovers pursuant to § 402(c)(11) with respect to such distributions without regard to plan terms.

Q–15. For what purposes is the direct rollover of a distribution by a nonspouse beneficiary treated as a rollover of an eligible rollover distribution?

A–15. Section 402(c)(11) provides that a direct rollover of a distribution by a nonspouse beneficiary is a rollover of an eligible rollover distribution only for purposes of § 402(c). Accordingly, the distribution is not subject to the direct rollover requirements of § 401(a)(31), the notice requirements of § 402(f), or the mandatory withholding requirements of § 3405(c). If an amount distributed from a plan is received by a nonspouse beneficiary, the distribution is not eligible for rollover.

Q–16. If the named beneficiary of a decedent is a trust, is a plan permitted to make a direct rollover to an IRA established with the trust as beneficiary?

A–16. Yes. A plan may make a direct rollover to an IRA on behalf of a trust where the trust is the named beneficiary of a decedent, provided the beneficiaries of the trust meet the requirements to be designated beneficiaries within the meaning of § 401(a)(9)(E). The IRA must be established in accordance with the rules in Q&A–13 of this notice, with the trust identified as the beneficiary. In such a case, the beneficiaries of the trust are treated as having been designated as beneficiaries of the decedent for purposes of determining the distribution period under § 401(a)(9), if the trust meets the requirements set forth in § 1.401(a)(9)–4, Q&A–5, with respect to the IRA.

Q–17. How is the required minimum distribution (an amount not eligible for rollover) determined with respect to a nonspouse beneficiary if the employee dies before his or her required beginning date within the meaning of § 401(a)(9)(C)?

A–17. (a) *General rule*. If the employee dies before his or her required beginning date, the required minimum distributions for purposes of determining the amount eligible for rollover with respect to a nonspouse beneficiary are determined under either the 5-year rule described in § 401(a)(9)(B)(ii) or the life expectancy rule described in § 401(a)(9)(B)(iii). See Q&A–4 of § 1.401(a)(9)–3 to determine which rule applies to a particular designated beneficiary. Under either rule, no amount is a required minimum distribution for the year in which the employee dies. The rule in Q&A–7(b) of § 1.402(c)–2 (relating to distributions before an employee has attained age 70½) does not apply to nonspouse beneficiaries.

(b) *Five-year rule*. Under the 5-year rule described in § 401(a)(9)(B)(ii), no amount is required to be distributed until the fifth calendar year following the year of the employee's death. In that year, the entire amount to which the beneficiary is entitled under the plan must be distributed. Thus, if the 5-year rule applies with respect to a nonspouse beneficiary who is a designated beneficiary within the meaning of § 401(a)(9)(E), for the first 4 years after the year the employee dies, no amount payable to the beneficiary is ineligible for direct rollover as a required minimum distribution. Accordingly, the beneficiary is permitted to directly roll over the beneficiary's entire benefit until the end of the fourth year (but, as described in Q&A–19 of this notice, the 5-year rule must also apply to the IRA to which the rollover contribution is made). On or after January 1 of the fifth year following the year in which the employee died, no amount payable to the beneficiary is eligible for rollover.

(c) *Life expectancy rule*. (1) *General rule*. If the life expectancy rule described in § 401(a)(9)(B)(iii) applies, in the year following the year of death and each subsequent year, there is a required minimum distribution. See Q&A–5(c)(1) of § 1.401(a)(9)–5 to determine the applicable distribution period for the nonspouse beneficiary. The amount not eligible for rollover includes all undistributed required minimum distributions for the year in which the direct rollover occurs and any prior year (even if the excise tax under § 4974 has been paid with respect to the failure in the prior years). See the last sentence of § 1.402(c)–2, Q&A–7(a).

(2) *Special rule*. If, under paragraph (b) or (c) of Q&A–4 of § 1.401(a)(9)–3, the 5-year rule applies, the nonspouse designated beneficiary may determine the required minimum distribution under the plan using the life expectancy rule in the case of a distribution made prior to the end of the year following the year of death. However, in order to use this rule, the required minimum distributions under the IRA to which the direct rollover is made must be determined under the life expectancy rule using the same designated beneficiary.

Q–18. How is the required minimum distribution with respect to a nonspouse beneficiary determined if the employee dies on or after his or her required beginning date?

A–18. If an employee dies on or after his or her required beginning date, within the meaning of § 401(a)(9)(C), for the year of the employee's death, the required minimum distribution not eligible for rollover is the same as the amount that would have applied if the employee were still alive and elected the direct rollover. For the year after the year of the employee's death and subsequent years, see Q&A–5 of § 1.401(a)(9)–5 to determine the applicable distribution period to use in calculating the required minimum distribution. As in the case of death before the employee's required beginning date, the amount not eligible for rollover includes all undistributed required minimum distributions for the year in which the direct rollover occurs and any prior year, including years before the employee's death.

Q–19. After a direct rollover by a nonspouse designated beneficiary, how is the required minimum distribution determined with respect to the IRA to which the rollover contribution is made?

A–19. Under § 402(c)(11), an IRA established to receive a direct rollover on behalf of a nonspouse designated beneficiary is treated as an inherited IRA within the meaning of § 408(d)(3)(C). The required minimum distribution requirements set forth in § 401(a)(9)(B) and the regulations thereunder apply to the inherited IRA. The rules for determining the required minimum distributions under the plan with respect to the nonspouse beneficiary also apply under the IRA. Thus, if the employee dies before his or her required beginning date and the 5-year rule in § 401(a)(9)(B)(ii) applied to the nonspouse designated beneficiary under the plan making the direct rollover, the 5-year rule applies for purposes of determining required minimum distributions under the IRA. If the life expectancy rule applied to the nonspouse designated beneficiary under the plan, the required minimum distribution under the IRA must be determined using the same applicable distribution period as would have been used under the plan if the direct rollover had not occurred. Similarly, if the employee dies on or after his or her required beginning date, the required minimum distribution under the IRA for any year after the year of death must be determined using the same applicable distribution period as would have been used under the plan if the direct rollover had not occurred.

VI. SECTION 845 OF PPA '06

Code § 402(l), which was added by § 845(a) of PPA '06, provides for an exclusion from gross income for distributions from certain retirement plans (referred to in this notice as "Eligible Government Plans") used to pay qualified health insurance premiums of an eligible retired public safety officer. The exclusion applies with respect to an eligible retired public safety officer who elects to have qualified health insurance premiums deducted from amounts distributed from an Eligible Government Plan and paid directly to the insurer. Qualified health insurance premiums include premiums for accident and health insurance or qualified long-term care insurance contracts for the eligible retired public safety officer and his or her spouse and dependents. The distribution is excluded from gross income to the extent that the aggregate amount of the distributions does not exceed the amount used to pay the qualified health insurance premiums of the eligible retired public safety officer and his or her spouse and dependents. An "Eligible Government Plan" is a governmental plan described in § 414(d) that is either: a § 401(a), § 403(a), or § 403(b) plan; or an eligible governmental plan under § 457(b). Section 402(l) applies to distributions in taxable years beginning after December 31, 2006.

Q–20. Who is an eligible retired public safety officer for purposes of the exclusion under § 402(l)?

A–20. An employee is an eligible retired public safety officer for purposes of the exclusion under § 402(l) only if the employee is an individual who separated from service, either by reason of disability or after attainment of normal retirement age, as a public safety officer with the employer who maintains the Eligible Government Plan from which the distributions to pay qualified health insurance premiums are made. Thus, a public safety officer who retires before attainment of normal retirement age is not an eligible retired public safety officer unless the public safety officer retires by reason of disability. The terms of the Eligible Government Plan from which the participant will be receiving the distributions apply in determining whether a public safety officer has separated from service by reason of disability or after attainment of normal retirement age.

Q–21. Who is a public safety officer?

A–21. For purposes of § 402(l), the term "public safety officer" means an individual serving a public agency in an official capacity, with or without compensation, as a law enforcement officer, a firefighter, a chaplain, or as a member of a rescue squad or ambulance crew. See § 1204(9)(A) of the Omnibus Crime Control and Safe Streets Act of 1968 (42 U.S.C. 3796b(9)(A)).

Q–22. Under what circumstances are the provisions of § 402(l) available for eligible retired public safety officers?

A–22. The favorable tax treatment under § 402(l) is available only when an eligible retired public safety officer elects to have an amount subtracted from his or her distributions from an Eligible Government Plan and such amount is used to pay qualified health insurance premiums. The employer sponsoring the Eligible Government Plan is not required to offer such an election.

Q–23. Can the accident or health plan receiving the payments of qualified health insurance premiums be a self-insured plan?

A–23. No. The accident or health plan must be an accident or health insurance plan. Thus, the plan must be providing insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance).

Q–24. Will an eligible retired public safety officer be entitled to favorable tax treatment under § 402(l) with respect to benefits attributable to service other than as a public safety officer?

A–24. Yes. Benefits attributable to service other than as a public safety officer are eligible for favorable tax treatment under § 402(l), as long as the individual separates from service as a public safety officer, by reason of disability or after attainment of normal retirement age, with the employer maintaining the Eligible Government Plan.

Q–25. If an eligible retired public safety officer dies, are amounts subtracted from distributions made to the decedent's surviving spouse or dependents eligible for favorable tax treatment under § 402(l)?

A–25. No. Section 402(l) provides that the distribution is not includible in the gross income of an employee who is an eligible retired public safety officer. Thus, the exclusion would not extend to amounts subtracted from distributions to other distributees.

Q–26. Is an eligible retired public safety officer limited in the amount that the officer can exclude from gross income for distributions from an Eligible Government Plan used to pay qualified health insurance premiums?

A–26. Yes. The aggregate amount that is permitted to be excluded, with respect to any taxable year, from an eligible retired public safety officer's gross income by reason of § 402(l) is limited to $3,000. For purposes of applying this $3,000 limitation, distributions with respect to the eligible retired public safety officer that are used to pay for qualified health insurance premiums from all Eligible Government Plans are aggregated.

Q–27. Are amounts used to pay qualified health insurance premiums that are excluded from gross income under § 402(l) taken into account for purposes of determining the itemized deduction for medical care expenses under § 213?

A–27. No. Amounts used to pay qualified health insurance premiums that are excluded from gross income under § 402(l) are not taken into account in determining the itemized deduction for medical care expenses under § 213.

VII. SECTION 904 OF PPA '06

Prior to the effective date of PPA '06 § 904, a defined contribution plan satisfied the minimum vesting requirements of Code § 411(a) with respect to employer nonelective contributions if it maintained a 5-year vesting schedule or a 3 to 7 year vesting schedule. Section 904 of PPA '06 amended the minimum vesting requirements to require faster vesting of employer nonelective contributions to a defined contribution plan. Under Code § 411(a)(2)(B) as amended by § 904 of PPA '06, a defined contribution plan satisfies the minimum vesting requirements with respect to employer nonelective contributions if it has a 3-year vesting schedule or a 2 to 6 year vesting schedule. Code § 411(a)(2)(B) as amended by § 904 of PPA '06 generally applies to contributions for plan years beginning after December 31, 2006.

Q–28. If a plan amendment changes the plan's vesting schedule to satisfy Code § 411(a)(2)(B) as amended by § 904 of PPA '06, is the plan amendment required to satisfy § 411(a)(10)?

A–28. Yes. A plan amendment that changes the vesting schedule must satisfy Code § 411(a)(10). Although § 411(a)(10)(B) would require a participant with at least 3 years of service to elect to have the nonforfeitable percentage of his accrued benefit determined without regard to the amendment, the plan must ensure that any such election satisfies the vesting requirements of § 411(a)(2)(B), as amended by § 904 of PPA '06. Thus, such a participant must be provided, at all times, a vesting percentage that is no less than the minimum under a vesting schedule that satisfies § 904 and the vesting percentage determined under the plan without regard to the amendment. Under Temporary Regulation § 1.411(a)–8T, no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment.

Q–29. Can a plan have separate vesting schedules for employer nonelective contributions that are and are not subject to Code § 411(a)(2)(B), as amended by § 904 of PPA '06?

A–29. Yes. A plan can have a vesting schedule for employer nonelective contributions for plan years beginning after December 31, 2006, and another vesting schedule for other employer nonelective contributions under the plan, provided that the plan separately accounts for the contributions made under the vesting schedule in effect prior to the first day of the first plan year beginning after December 31, 2006, and the vesting schedule for employer nonelective contributions for plan years beginning after December 31, 2006, satisfies Code § 411(a)(2)(B), as amended by § 904 of PPA '06.

Q–30. If a plan maintains a bifurcated vesting schedule, how is it determined whether a contribution is for a plan year beginning before January 1, 2007?

A–30. A contribution is for a plan year that begins before January 1, 2007, if it is allocated under the terms of the plan as of a date in that plan year and is not subject to any conditions that have not been satisfied by the end of that plan year. This applies even if the contribution is not made until the next plan year. Thus, for example, if a plan with a calendar-year plan year makes a contribution as of December 31, 2006, based on compensation and service in 2006, and the contribution is not contingent on the occurrence of an event after 2006, then the contribution is treated as made for the 2006 plan year and is not subject to Code § 411(a)(2)(B), as amended by § 904 of PPA '06, even if it is not contributed until 2007. Forfeitures and ESOP allocations from a suspense account are treated in the same manner for this purpose.

VIII. SECTION 1102 OF PPA '06

Section 1102 of PPA '06 makes certain changes to the notice requirements related to distributions. Section 1102(a) provides that a notice required to be provided under § 402(f), § 411(a)(11), or § 417 may be provided to a participant as much as 180 days before the annuity starting date. Section 1102(b) directs the Secretary to modify the regulations under § 411(a)(11) of the Code and § 205 of ERISA to provide that the description of a participant's right to defer a distribution must also include a description of the consequences of failing to defer receipt of a distribution. The modifications made by § 1102 apply to years beginning after December 31, 2006. However, § 1102(b)(2)(B) provides that a plan will not be treated as failing to meet the new requirements under § 1102(b) if the plan administrator makes a reasonable attempt to comply with the new requirements under that section during the period that is within 90 days of the issuance of regulations required by § 1102(b).

Q–31. How does the effective date of § 1102 operate?

A–31. The provisions of § 1102 apply to plan years that begin after December 31, 2006. This means that the new rules relating to the content of the notices apply only to notices issued in those plan years, without regard to the annuity starting date for the distributions. Similarly, the 180-day period for distributing notices applies to notices distributed in a plan year that begins after December 31, 2006. This change to the 180-day period also modifies the definition of the maximum QJSA explanation period under § 1.411(d)–3(g), which is used in applying the timing rules for the effective date of a plan amendment under the rules of § 1.411(d)–3(c) and (f) in the case of an amendment that is adopted in a plan year that begins after December 31, 2006.

Q–32. Is a plan required to revise the notice under § 411 pursuant to the modifications made by § 1102(b) before the regulations are amended to reflect the requirement?

A–32. Yes. A plan administrator is required to revise the notice under § 411 to reflect the modifications to the requirements made by § 1102(b) for notices provided in plan years beginning after December 31, 2006. However, pursuant to § 1102(b)(2)(B) of PPA '06, a plan will not be treated as failing to meet the new requirements under § 1102(b) if the plan administrator makes a reasonable attempt to comply with the new requirements under that section in the case of a notice that is provided prior to the 90th day after the issuance of regulations reflecting the modifications required by § 1102(b).

Q–33. Is there a safe harbor available to a plan administrator that would be considered a reasonable attempt to comply with the requirement in § 1102(b)(1) that a description of a participant's right to defer receipt of a distribution include a description of the consequences of failing to defer?

A–33. Yes. A description that is written in a manner reasonably calculated to be understood by the average participant and that includes the following information is a reasonable attempt to comply with the requirements of § 1102(b)(2)(B): (a) in the case of a defined benefit plan, a description of how much larger benefits will be if the commencement of distributions is deferred; (b) in the case of a defined contribution plan, a description indicating the investment options available under the plan (including fees) that will be available if distributions are deferred; and (c) the portion of the summary plan description that contains any special rules that might materially affect a participant's decision to defer. For purposes of clause (a), a plan administrator can use a description that includes the financial effect of deferring distributions, as described in § 1.417(a)(3)–1(d)(2)(i), based solely on the normal form of benefit.

IX. SECTION 1201 OF PPA '06

Section 1201(a) of PPA '06 adds § 408(d)(8) to the Code, which is applicable to distributions made in taxable years 2006 and 2007. Under § 408(d)(8), generally, if a distribution from an IRA owned by an individual after the individual has attained age 70½ is made directly by the trustee to certain organizations described in § 170(b)(1)(A), the distribution is excluded from gross income. The exclusion is only available to the extent that the distribution would otherwise have been includible in gross income, and § 408(d)(8)(D) provides a special rule for determining the amount that would otherwise be includible in gross income. In addition, the exclusion applies only if the contribution would otherwise qualify for a charitable contribution deduction under § 170 (without regard to the percentage limitations of § 170(b)). A distribution that is eligible for this exclusion is called a qualified charitable distribution.

Q–34. Is there an overall limit on the amount that may be excluded from gross income for qualified charitable distributions that are made in a year?

A–34. Yes. The income exclusion for qualified charitable distributions only applies to the extent that the aggregate amount of qualified charitable distributions made during any taxable year with respect to an IRA owner does not exceed $100,000. Thus, if an IRA owner maintains multiple IRAs in a taxable year, and qualified charitable distributions are made from more than one of these IRAs, the maximum total amount that may be excluded for that year by the IRA owner is $100,000. For married individuals filing a joint return, the limit is $100,000 per individual IRA owner.

Q–35. Is the exclusion for qualified charitable distributions available for a distribution made to any organization eligible to receive charitable contributions that are deductible by the donor for income tax purposes?

A–35. No. Qualified charitable distributions may be made to an organization described in § 170(b)(1)(A), other than supporting organizations described in

§ 509(a)(3) or donor advised funds that are described in § 4966(d)(2).

Q–36. Is the exclusion for qualified charitable distributions available for distributions from any type of IRA?

A–36. Generally, the exclusion for qualified charitable distributions is available for distributions from any type of IRA (including a Roth IRA described in § 408A and a deemed IRA described in § 408(q)) that is neither an ongoing SEP IRA described in § 408(k) nor an ongoing SIMPLE IRA described in § 408(p). For this purpose, a SEP IRA or a SIMPLE IRA is treated as ongoing if it is maintained under an employer arrangement under which an employer contribution is made for the plan year ending with or within the IRA owner's taxable year in which the charitable contributions would be made.

Q–37. Is the exclusion for qualified charitable distributions available for distributions from an IRA maintained for a beneficiary if the beneficiary has attained age 70½ before the distribution is made?

A–37. Yes. The exclusion from gross income for qualified charitable distributions is available for distributions from an IRA maintained for the benefit of a beneficiary after the death of the IRA owner if the beneficiary has attained age 70½ before the distribution is made.

Q–38. If a 2006 distribution satisfies all the requirements under § 408(d)(8), but it was made before August 17, 2006 (the date PPA '06 was enacted), is the amount distributed excludable as a qualified charitable distribution?

A–38. Yes. Section 408(d)(8) is applicable to distributions made at any time in 2006. Thus, a distribution made in 2006 that satisfies the requirements under § 408(d)(8) is a qualified charitable distribution even if it was made before August 17, 2006.

Q–39. Is the amount of a qualified charitable distribution deductible as a charitable contribution under § 170?

A–39. No. For purposes of determining the amount of charitable contributions that may be deducted under § 170, qualified charitable distributions which are excluded from income under § 408(d)(8) are not taken into account. However, qualified charitable distributions must still satisfy the requirements to be deductible charitable contributions under § 170 (other than the percentage limits of § 170(b)), including the substantiation requirements under § 170(f)(8).

Q–40. Is a qualified charitable distribution subject to withholding under § 3405?

A–40. No. A qualified charitable distribution is not subject to withholding under § 3405 because an IRA owner that requests such a distribution is deemed to have elected out of withholding under § 3405(a)(2). For purposes of determining whether a distribution requested by an IRA satisfies the requirements under § 408(d)(8), the IRA trustee, custodian, or issuer may rely upon reasonable representations made by the IRA owner.

Q–41. Is a check from an IRA made payable to a charitable organization described in § 408(d)(8) and delivered by the IRA owner to the charitable organization a direct payment to such organization?

A–41. Yes. If a check from an IRA is made payable to a charitable organization described in § 408(d)(8) and delivered by the IRA owner to the charitable organization, the payment to the charitable organization will be considered a direct payment by the IRA trustee to the charitable organization for purposes of § 408(d)(8)(B)(i).

Q–42. Will a qualified charitable distribution be taken into account in determining whether the required minimum distribution requirements of §§ 408(a)(6), 408(b)(3), and 408A(c)(5) have been satisfied?

A–42. Yes. The amount distributed in a qualified charitable distribution is an amount distributed from the IRA for purposes of §§ 408(a)(6), 408(b)(3), and 408A(c)(5).

Q–43. What are the tax consequences of a direct payment of an amount from an IRA to a charity where the transaction is intended to satisfy the requirements of § 408(d)(8) but fails to do so?

A–43. If an amount intended to be a qualified charitable distribution is paid to a charitable organization but fails to satisfy the requirements of § 408(d)(8), the amount paid is treated as (1) a distribution from the IRA to the IRA owner that is includible in gross income under the rules of § 408 or § 408A, as applicable; and (2) a contribution from the IRA owner to the charitable organization that is subject to the rules under § 170 (including the percentage limits of § 170(b)).

Q–44. Will a distribution made directly by the trustee to a § 170(b)(1)(A) organization (as permitted by § 408(d)(8)(B)(i)) be treated as a receipt by the IRA owner under § 4975(d)(9)?

A–44. Yes. The Department of Labor, which has interpretive jurisdiction with respect to § 4975(d), has advised Treasury and the IRS that a distribution made by an IRA trustee directly to a § 170(b)(1)(A) organization (as permitted by § 408(d)(8)(B)(i)) will be treated as a receipt by the IRA owner under § 4975(d)(9), and thus would not constitute a prohibited transaction. This would be true even if the individual for whose benefit the IRA is maintained had an outstanding pledge to the receiving charitable organization.

DRAFTING INFORMATION

The principal author of this notice is Angelique V. Carrington of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans taxpayer assistance telephone service at (877) 829–5500 (a toll-free number) between the hours of 8:30 am and 4:30 pm Eastern Time, Monday through Friday. Ms. Carrington may be reached at (202) 283–9888 (not a toll-free number).

Look-thru Rule for Related Controlled Foreign Corporations

Notice 2007–9

SECTION 1. OVERVIEW

This notice provides guidance under section 954(c)(6) of the Internal Revenue Code (Code) enacted by the Tax Increase Prevention and Reconciliation Act of 2005 and amended by the Tax Relief and Health Care Act of 2006. In general, and subject to certain limitations, section 954(c)(6) provides that dividends, interest, rents, and royalties received or accrued by one controlled foreign corporation (CFC) from another CFC which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States (ECI). The provisions of section 954(c)(6) apply to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of the foreign corporations end.

The Internal Revenue Service (IRS) and the Treasury Department intend to issue additional guidance concerning section 954(c)(6). The IRS and the Treasury Department expect to issue regulations that incorporate the guidance provided in this notice and in any subsequent guidance.

SECTION 2. BACKGROUND

Section 951(a)(1) provides that if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of such corporation and who owns stock in such corporation on the last day, in such year, on which such corporation is a CFC shall include in its gross income, for its taxable year in which or with which such taxable year of the corporation ends, its *pro rata* share of the corporation's subpart F income for such year.

Section 957(a) defines a CFC as any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote, or more than 50 percent of the total value of the stock of such corporation, is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such corporation. Section 951(b) defines a United States shareholder as a United States 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 952(a)(2) provides that subpart F income includes foreign base company income (FBCI). Subject to certain exceptions, section 954(a)(1) provides that FBCI includes foreign personal holding company income (FPHCI) for the taxable year. Section 954(c)(1)(A) provides that FPHCI includes dividends, interest, royalties, rents, and annuities. Section 954(c) also provides special rules and exceptions to the definition of FPHCI (*e.g.*, sections 954(c)(2) and (3)).

Section 103(b) of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) (P.L. 109–222), enacted on May 17, 2006, added section 954(c)(6) to the Code. Section 426(a) of Division A of the Tax Relief and Health Care Act of 2006 (P.L. 109–432), enacted on December 20, 2006, made technical corrections to section 954(c)(6).

Section 954(c)(6)(A) provides that for purposes of section 954(c), dividends, interest, rents, and royalties received or accrued from a CFC which is a related person shall not be treated as FPHCI to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is neither subpart F income nor ECI (section 954(c)(6) exception). For this purpose, interest includes factoring income which is treated as income equivalent to interest for purposes of section 954(c)(1)(E). Section 954(c)(6)(A) also provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provision, including regulations to prevent the abuse of the purposes of the provision.

Section 954(c)(6)(B) provides that subparagraph (A) applies to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of the foreign corporations end.

For purposes of section 954(c)(6), a related person has the meaning provided in section 954(d)(3) and Treas. Reg. § 1.954–1(f). The CFCs must be related persons only at the time the particular dividend, interest, rent, or royalty in question is received or accrued. The section 954(c)(6) exception is not elective, and so applies to all covered transactions.

SECTION 3. DIVIDENDS

For purposes of section 954(c)(6), the term "dividend" has the meaning provided in section 316(a), including any amount treated as a section 301(c)(1) distribution as a result of a redemption described in either section 302 or section 304. That term also includes gains treated as dividends pursuant to sections 964(e) and 356(a)(2).

If a CFC is an exchanging shareholder and includes in income as a deemed dividend the all earnings and profits amount pursuant to Treas. Reg. § 1.367(b)–3(b)(3)(i), such inclusion is not eligible for the section 954(c)(6) exception.

With respect to the types of dividends above that are eligible for the section 954(c)(6) exception, the earnings and profits of the distributing CFC need not be accumulated during a period when it was a CFC, or during a period when the CFC receiving the dividend was a related person. The key requirement in this regard is that the relevant CFCs are related persons at the time the dividend is received.

Dividends are not eligible for the section 954(c)(6) exception to the extent they are distributed out of earnings and profits that are attributable to subpart F income or income that is (or is treated as) ECI. Because of the way the subpart F rules operate, distributions of earnings from a CFC to a related CFC typically will not be attributable to subpart F income for purposes of the section 954(c)(6) exception. Such a distribution will be attributable either to earnings and profits which are, or have been, included in a United States shareholder's gross income under section 951(a) (*i.e.*, previously taxed income) or, to the extent the distributions are attributable to earnings and profits that are not PTI, to income that is not subpart F income. Dividends that are attributable to income that is (or is treated as) ECI are not eligible for the section 954(c)(6) exception.

SECTION 4. PARTNERSHIPS

If interest is received or accrued from a partnership with one or more partners that are CFCs, such interest will be treated as received or accrued from a CFC for purposes of section 954(c)(6) to the extent that such CFC partner would be treated as the payor of the interest under Treas. Reg. § 1.954–2(b)(4)(i)(B). Similarly, if rents or royalties are received or accrued from a partnership with one or more partners that are CFCs, such rents or royalties will be treated as received or accrued from a CFC for purposes of section 954(c)(6) to the extent that such CFC partner would be treated as the payor of the rents or royalties under Treas. Reg. § 1.954–2(b)(5)(i)(B).

If dividends, interest, rents, or royalties are received by a partnership with one or more partners that are CFCs, such amounts will be treated as received or accrued by a CFC for purposes of section 954(c)(6) to the extent provided under Treas. Reg. §§ 1.702–1(a)(8)(ii), 1.952–1(g), and 1.954–1(g), as applicable.

SECTION 5. ALLOCATION AND ATTRIBUTION RULES FOR INTEREST

This section applies for purposes of determining the extent to which interest is attributable or properly allocable to income of the related person which is neither subpart F income nor ECI.

(a) *Interest properly allocable or apportionable to non-subpart F income*

Interest is not eligible for the section 954(c)(6) exception to the extent the deduction for the interest payment is allocated and apportioned under section 954(b)(5) and Treas. Reg. § 1.954–1(a)(4) and (c) to reduce the related CFC payor's adjusted gross FBCI (as defined in Treas. Reg. § 1.954–1(a)(3)), adjusted gross insurance income (as defined in Treas. Reg. § 1.954–1(a)(6)), or any other category of income included in subpart F income under section 952(a).

In general, interest that is allocated and apportioned to income that is not subpart F income is eligible for the section 954(c)(6) exception (subject to the rules below for ECI), even if interest deductions exceed the gross income of the related CFC payor in the year paid or accrued. However, interest is not eligible for the section 954(c)(6) exception to the extent interest deductions create (or increase) a deficit which under section 952(c) may reduce the subpart F income of the related CFC payor or another CFC.

(b) *Interest properly allocable or apportionable to non-ECI*

Interest is not eligible for the section 954(c)(6) exception to the extent the deduction for the interest payment is allocated and apportioned under section 882(c) and Treas. Reg. § 1.882–5, to gross income of the related CFC payor that is (or is treated as) ECI, or as expressly provided by or pursuant to a U.S. income tax treaty or accompanying documents (such as an exchange of notes), is allocated and apportioned to gross income of the related CFC payor that is attributable to a U.S. permanent establishment.

This paragraph applies if, in a single taxable year, the related CFC payor incurs both interest expense that, but for the application of section 5(b) of this notice, is eligible for the section 954(c)(6) exception (section 954(c)(6) interest expense), and other interest expense. In such a case, the amount of interest expense that is treated as allocated and apportioned to gross income of the related CFC payor that is (or is treated as) ECI, or under an applicable treaty, that is allocated and apportioned to gross income of the related CFC payor that is attributable to a U.S. permanent establishment, is the related CFC payor's interest expense for the taxable year multiplied by a fraction equal to the amount of section 954(c)(6) interest expense over the related CFC payor's total interest expense incurred during the taxable year.

Interest is not eligible for the section 954(c)(6) exception to the extent interest deductions create (or increase) a net operating loss carryover that is effectively connected with the conduct of a trade or business within the United States (or that is attributable to a permanent establishment, in the context of an applicable U.S. income tax treaty).

SECTION 6. ALLOCATION AND ATTRIBUTION RULES FOR RENTS AND ROYALTIES

This section applies for purposes of determining the extent to which rents and royalties are attributable or properly allocable to income of the related person which is neither subpart F income nor ECI.

(a) *Rents and royalties properly allocable or apportionable to non-subpart F income*

Rents and royalties are not eligible for the section 954(c)(6) exception to the extent the deductions for the rent or royalty payments are allocated and apportioned under section 954(b)(5) and Treas. Reg. § 1.954–1(a)(4) and (c) to reduce the related CFC payor's adjusted gross FBCI (as defined in Treas. Reg. § 1.954–1(a)(3)), adjusted gross insurance income (as defined in Treas. Reg. § 1.954–1(a)(6)), or any other category of income included in subpart F income under section 952(a).

In general, rents and royalties that are allocated and apportioned to income that is not subpart F income are eligible for the section 954(c)(6) exception (subject to the rules below for ECI), even if deductions for such amounts exceed the gross income of the related CFC payor in the year paid or accrued. However, rents and royalties are not eligible for the section 954(c)(6) exception to the extent deductions for such amounts create (or increase) a deficit which under section 952(c) may reduce the subpart F income of the related CFC payor or another CFC.

(b) *Rents and royalties properly allocable or apportionable to non-ECI*

Rents and royalties are not eligible for the section 954(c)(6) exception to the extent the deductions for the rent or royalty payments are allocated and apportioned under section 882(c) and Treas. Reg. § 1.861–8, to gross income of the related CFC payor that is (or is treated as) ECI.

Rents and royalties are not eligible for the section 954(c)(6) exception to the extent deductions for such amounts create (or increase) a net operating loss carryover that is effectively connected with the conduct of a trade or business within the United States.

SECTION 7. ANTI-ABUSE RULES

(a) *Overview*

In addition to the general grant of regulatory authority, section 954(c)(6)(A) specifically grants the Secretary the authority to prescribe regulations to prevent the abuse of the purposes of section 954(c)(6). The transactions described below are abusive of the purposes of section 954(c)(6). However, the IRS and the Treasury Department do not intend this to be an exclusive list of abusive transactions and expect to provide further anti-abuse rules in subsequent guidance. For example, the IRS and the Treasury Department are considering a rule similar to the one described in section 7(d) of this notice for principal purpose domestic partnerships.

(b) *Amounts that reduce the U.S. income tax base, including factoring income*

Transactions abuse the purposes of section 954(c)(6) if they reduce income from the U.S. income tax base by having the net effect of creating a deduction of a payment, accrual, or loss of a person subject to U.S. tax without a corresponding inclusion in the subpart F income of the CFC recipient, where such inclusion would have resulted in the absence of section 954(c)(6).

For purposes of section 954(c)(6), interest includes factoring income which is treated as income equivalent to interest for purposes of section 954(c)(1)(E) and interest described in section 864(d) (collectively, factoring income). However, certain factoring income is not eligible for the section 954(c)(6) exception. Any factoring income derived from a transaction which has the net effect of creating a deduction of a payment, accrual, or loss of a person subject to U.S. tax without a corresponding inclusion in the subpart F income of the CFC recipient, where such inclusion would have resulted in the absence of section 954(c)(6), is not eligible for the section 954(c)(6) exception. The following example illustrates the application of this paragraph:

Example. (i) *Facts*. USP, a domestic corporation, owns 100% of the stock of CFC1 and CFC2. USP sells inventory to CFC1 in exchange for receivables. USP sells the CFC1 receivables to CFC2 at a discount, and CFC2 generates income on the collection of the CFC1 receivables.

(ii) *Analysis*. The income earned by CFC2 on the collection of receivables is related person factoring income as defined in section 864(d) and, therefore, is treated as interest income received on a loan from CFC2 to CFC1. However, because CFC2 acquired the CFC1 receivables from USP at a discount, resulting in a current loss for USP, such interest income is not eligible for the section 954(c)(6) exception.

(c) *Avoidance of section 956*

If a dividend reduces or eliminates the applicable earnings of a CFC, within the meaning of section 956(b)(1), such that it reduces a U.S. shareholder's inclusion pursuant to section 951(a)(1)(B), the dividend is not eligible for the section 954(c)(6) exception. See also Treas. Reg. § 1.956–1T(b)(4). The following example illustrates the application of this paragraph:

Example. (i) *Facts*. USP, a domestic corporation, owns 100% of the stock of CFC1 which, in turn, owns 100% of the stock of CFC2. At the beginning of Year 1, at a time when the stock of CFC2 has a value of $300 and CFC2 has zero applicable earnings (within the meaning of section 956(b)(1)), CFC2 loans $100 to USP in exchange for a note. During Year 1, CFC2 generates $100 of non-subpart F earnings and profits. Shortly before the end of Year 1, CFC2 distributes $100 to CFC1 that results in a $100 dividend to CFC1 and, as a result, CFC2 takes the position that it's applicable earnings under section 956(b)(1) are reduced from $100 to $0.

(ii) *Analysis*. The USP note held by CFC2 is United States property (within the meaning of section 956(c)(1)(C)), and CFC2 generated $100 of earnings and profits during Year 1. As a result, USP would have an income inclusion of $100 pursuant to section 951(a)(1)(B), but for the applicable earnings limitation under section 956(b)(1). However, as a result of the Year 1 dividend CFC2 paid to CFC1, CFC2 does not have any applicable earnings and USP, therefore, would not have a section 951(a)(1)(B) inclusion. Thus, the dividend income of CFC1 is not eligible for the section 954(c)(6) exception.

(d) *Use of options or similar interests*

When the use of options or similar interests causes a foreign corporation to become a CFC payor, and a principal purpose for the use of the options or similar interests is to qualify dividends, interest, rents, or royalties paid by the foreign corporation for the section 954(c)(6) exception, the dividends, interest, rents, or royalties received or accrued from such foreign corporation will not be treated as being received or accrued from a CFC payor and, therefore, will not be eligible for the section 954(c)(6) exception. For purposes of this paragraph, an interest that is similar to an option includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock.

(e) *Change of character of income through the use of a conduit entity*

When a transaction changes the character of the underlying income, is effected through the use of a conduit entity, and a principal purpose for the use of the conduit entity is to qualify the underlying income for the section 954(c)(6) exception, the dividends, interest, rents, or royalties received or accrued will not be treated as being received or accrued from a related CFC and, therefore, will not be eligible for the section 954(c)(6) exception. The following example illustrates the application of this paragraph:

Example. (i) *Facts*. USP, a domestic corporation, owns 100% of the stock of CFC1, a country Y corporation, and CFC2, a country Z corporation. FC, a country Z corporation, is not a CFC, but is a related person under section 954(d)(3). In year 1, FC leases property from CFC1 for $100. USP causes the rental payment to be made through CFC2. Thus, CFC2 receives a payment from FC that is excluded from FPHCI under section 954(c)(3)(A)(i). CFC2 then makes a payment to CFC1, in satisfaction of the rent owed by FC, which is intended to qualify for the section 954(c)(6) exception. A principal purpose for the involvement of CFC2 in the transaction is to qualify the rental payment from FC to CFC1 as eligible for the section 954(c)(6) exception.

(ii) *Analysis*. If the rental payment had been made directly from FC to CFC1, it would have been included as FPHCI under section 954(c)(1)(A). By causing the payment to be made through CFC2, USP sought to convert the character of the income from FPHCI to income excluded from FPHCI. However, because a principal purpose of including CFC2 in the transaction as a conduit entity was to avoid inclusion of the rental payment from FC to CFC1 as FPHCI, the payment from CFC2 to CFC1 will be treated as being made from FC to CFC1. Therefore, the payment is not eligible for the section 954(c)(6) exception.

SECTION 8. EFFECTIVE DATE

Sections 3, 4, 5, 6, 7(b) and 7(c) of this notice are effective for taxable years of foreign corporations beginning after December 31, 2005. Sections 7(d) and 7(e) of this notice are effective for taxable years of foreign corporations beginning after December 31, 2006.

SECTION 9. DRAFTING INFORMATION

The principal author of this notice is Paul J. Carlino of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Mr. Carlino at (202) 622–3840 (not a toll-free call).

Request for Comments

Comments may be submitted to CC:PA:LPD:PR (Notice 2007–9), Room 5203, Internal Revenue Service, PO Box 7604, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111

Constitution Avenue, NW, Washington, DC 20224, Attn: CC:PA:LPD:PR (Notice 2007–9) Room 5203. Submissions may also be sent electronically via the internet to the following email address: *Notice.comments@irscounsel.treas.gov*. Include the notice number (Notice 2007–9) in the subject line.

Communications Excise Tax; Toll Telephone Service

Notice 2007–11

SECTION 1. PURPOSE

This notice amplifies, clarifies, and modifies Notice 2006–50, 2006–25 I.R.B. 1141. That notice provides that the tax imposed by § 4251 of the Internal Revenue Code (relating to communications excise tax) does not apply to amounts paid for long distance service and bundled service (collectively, nontaxable service) and also provides that taxpayers may request a credit or refund of tax on nontaxable service that was billed to the taxpayer after February 28, 2003, and before August 1, 2006, only on their 2006 federal income tax returns. This notice—

(a) Provides the conditions under which individual taxpayers may use the standard amounts announced in IR–2006–137 (August 31, 2006) on their 2006 federal income tax returns to request a credit or refund of the excise tax paid on nontaxable service;

(b) Provides guidance regarding the Business and Nonprofit Estimation Method, announced in IR–2006–179 (November 16, 2006);

(c) Answers questions that have been raised since the issuance of Notice 2006–50; and

(d) Modifies the requirement for claims filed on or before May 25, 2006.

SECTION 2. BACKGROUND

For the statutory background of the tax imposed by § 4251, see section 2 of Notice 2006–50. When used in this notice, *local-only service*, *long distance service*, and *nontaxable service* have the meaning given to the terms in section 3 of Notice 2006–50. *Bundled service* has the meaning given to the term by section 5 of this notice.

SECTION 3. STANDARD AMOUNT

(a) *Conditions to allowance of standard amount*. A request for credit or refund of the standard amount, instead of the actual amount of federal communications excise tax paid for nontaxable service, may be made on a 2006 Form 1040 Series, *U.S. Individual Income Tax Return*, if any person filing the return, or any dependent listed on the return—

(1) Paid for any nontaxable service (other than for a prepaid telephone card or prepaid cellular telephone) that was billed to the taxpayer after February 28, 2003, and before August 1, 2006;

(2) Paid all federal communications excise taxes billed by their telecommunications provider after February 28, 2003, and before August 1, 2006;

(3) Has not received a credit or refund of these taxes from the telecommunications provider;

(4) Has not requested a credit or refund from the telecommunications provider or, if so requested, has withdrawn any such request; and

(5) Did not file any other claim or request for credit or refund with the IRS for the federal communications excise tax for a period after February 28, 2003.

(b) *Calculating standard amounts*—(1) *In general*—(i) *2006 Form 1040 Series (other than EZ)*. To determine the standard amount, taxpayers must first determine the number of exemptions for which they are entitled on their 2006 Form 1040 Series federal income tax return (other than the 2006 Form 1040 EZ). The Instructions to the 2006 Form 1040 Series federal income tax return and Publication 501, *Exemptions, Standard Deduction, and Filing Information*, provide guidance on determining the correct number of exemptions. Once the individual determines the number of exemptions, the individual can select the appropriate standard amount based upon the number of those exemptions. Individuals should refer to the 2006 federal income tax return instructions to ensure that the standard amount is entered on the appropriate part of the return.

(ii) *2006 Form 1040 EZ*. On line 5, a taxpayer that checks the box for "you" is treated as having one exemption. A taxpayer that checks the boxes for "you" and "spouse" is treated as having two exemptions.

(2) *Amounts*—(i) For each 2006 Form 1040 Series federal income tax return filed showing one exemption for purposes of determining the standard amount, the standard amount allowed on that return is $30.

(ii) For each 2006 Form 1040 Series federal income tax return filed showing two exemptions for purposes of determining the standard amount, the standard amount allowed on that return is $40.

(iii) For each 2006 Form 1040 Series federal income tax return filed showing three exemptions for purposes of determining the standard amount, the standard amount allowed on that return is $50.

(iv) For each 2006 Form 1040 Series federal income tax return filed showing four or more exemptions for purposes of determining the standard amount, the standard amount allowed on that return is $60.

(c) *Interest*. The standard amount represents both the overpayment of the federal communications excise tax paid on nontaxable service and the interest on that overpayment.

(d) *Actual Amounts*. To request a credit or refund for the actual amount of federal communications excise tax paid, taxpayers must complete Form 8913, *Credit for Federal Telephone Excise Tax Paid*, and attach that form to their 2006 Form 1040 Series federal income tax return.

(e) *Examples*. The following examples illustrate the application of this section.

Example 1. A, an individual, files a joint return with Z, A's spouse. A meets the conditions to allowance described in paragraph (a) of this section. A used the 2006 federal income tax return instructions to determine that their correct number of exemptions is two. A may request the credit or refund of the federal communications excise tax under § 4251 for $40.

Example 2. B, an individual, used the 2006 federal income tax return instructions to determine that she had one exemption. B further used her telephone bills for the period March 1, 2003, through July 31, 2006, to determine that the total amount paid for federal communications excise tax under § 4251 for nontaxable service to all telecommunications providers was $45. Completing Form 8913 and attaching it to her 2006 Form 1040 Series federal income tax return, B may request a credit or refund of $45, the actual amount she paid in federal communications excise tax on nontaxable service under § 4251. As an alternative, B may request a credit or refund of the standard amount of $30 without having to complete Form 8913.

SECTION 4. DISTINCTION BETWEEN LOCAL-ONLY SERVICE AND BUNDLED SERVICE

(a) *Technology for transmitting telephone call*. The method for sending or receiving a call, such as on a landline telephone, wireless (cellular) telephone or some other method, does not affect whether a service is local-only or bundled.

(b) *Combined local exchanges*. If two or more telecommunications providers combine their resources to expand the geographic area that each treats as "local" service and each bills its customers for that service as local-only service, then that service is local-only service.

(c) *Billing method*. Section 3(a) of Notice 2006–50 and section 5 of this notice provide that bundled service is local and long distance service provided under a plan that does not separately state the charge for the local telephone service. Thus, if local and long distance service is billed to a customer on a single bill but the telecommunications company separately states the amount paid for local-only service and the amount paid for long distance service, the amount paid for local-only service is subject to federal communications excise tax.

(d) *Examples*. The following examples illustrate the application of this section.

Example 1. Customer A purchases telecommunications service from B, a telecommunications provider. Such service includes both local-only service and long distance service. B's bill to A states $X for telecommunications service. The bill does not separately state a charge for either local-only service or long distance service. Since the bill does not separately state the charge for local-only service, the service is a bundled service. Thus, the entire amount of A's telecommunications service is bundled service and thus nontaxable service.

Example 2. Customer C purchases telecommunications service from D, a telecommunications provider. Such service includes both local-only service and long distance service. D's bill to C states $X amount for telecommunications service. The bill further states $Y amount for local-only service and $Z amount for long distance service. Since the charges for local-only service and long distance service are separately stated, the service is not bundled service. Accordingly, only the amounts charged for long distance service are for nontaxable service; tax is imposed on the amounts paid for the local-only service.

SECTION 5. CLARIFICATION OF DEFINITION OF BUNDLED SERVICE

(a) *Present definition*. Section 3(a) of Notice 2006–50 defines bundled service as local and long distance service provided under a plan that does not separately state the charge for the local telephone service. Bundled service includes, for example, Voice over Internet Protocol service, prepaid telephone cards, and plans that provide both local and long distance service for either a flat monthly fee or a charge that varies with the elapsed transmission time for which the service is used. Telecommunications companies provide bundled service for both landline and wireless (cellular) service.

(b) *Reason for clarification*. The example in the second sentence of the definition of bundled service incorrectly assumes that all Voice over Internet Protocol (VoIP) service would provide both local and long distance service and that the charges for the two services would not be separately stated. As noted in section 4(a) of this notice, the method of transmitting a call is not a factor in determining whether a service is local-only or bundled. Accordingly, a VoIP service that provides local-only service is treated as local-only service.

(c) *Revised definition*. Accordingly, the definition of bundled service is clarified to read as follows:

> Bundled service is local and long distance service provided under a plan that does not separately state the charge for the local telephone service. Bundled service includes plans that provide both local and long distance service for either a flat monthly fee or a charge that varies with the elapsed transmission time for which the service is used. Telecommunications companies provide bundled service for both landline and wireless (cellular) service. If Voice over Internet Protocol service provides both local and long distance service and the charges are not separately stated, such service is bundled service.

SECTION 6. PREPAID TELEPHONE CARDS (PTC)

(a) *In general*—(1) *Prepaid telephone cards*. Section 4251(d) and § 49.4251–4 of the Facilities and Services Excise Taxes Regulations provide rules for prepaid telephone cards (PTC). Section 49.4251–4(b) defines PTC as a card or similar arrangement that permits its holder to obtain a fixed amount of communications services by means of a code (such as a personal identification number (PIN)) or other access device provided by the carrier and to pay for those services in advance. The amount paid for PTCs is determined under the rules of §§ 4251(d)(1) and (2) and § 49.4251–4(c). Under this notice, the PTC will be treated as nontaxable service unless a PTC expressly states it is for local-only service.

(2) *Other cards*. This section does not address cards that permit the holder to purchase various services in addition to telecommunications services. Such services include, but are not limited to, ring tone downloads, music downloads, text messaging, picture messaging, web browsing, game downloads, or screen saver downloads.

(b) *Application of the tax*—(1) *Definitions*. Section 49.4251–4(b) provides that—

(i) *Carrier* means a telecommunications carrier as defined in 47 U.S.C. 153.

(ii) *Holder* means a person that purchases other than for resale.

(iii) *Transferee* means the first person that is not a carrier to whom a PTC is transferred by a carrier.

(2) *Imposition, liability, and collection*. Section 4251(d) provides that the § 4251 tax is imposed on the transfer of a PTC to a transferee; § 49.4251–4(d)(1) provides that the person liable for the tax is the transferee and that the person responsible for collecting the tax generally is the carrier transferring the PTC to the transferee. Section 49.4251–4(d)(1) further provides that if a holder purchases a PTC from a transferee reseller, the amount the holder pays for the PTC is not treated as an amount paid for communications services and thus tax is not imposed on that payment.

(c) *Person eligible to request credit or refund*. The transferee is the person liable for the tax paid on a PTC and thus generally is the person eligible to request a credit or refund of the tax it paid. The carrier is eligible to request a credit or refund only if it meets the conditions of section 5(d)(4) of Notice 2006–50. The holder is not liable for the tax and thus cannot request a credit or refund.

SECTION 7. PREPAID CELLULAR TELEPHONES

(a) *In general*—(1) *Prepaid cellular telephones*. Certain telecommunications providers offer wireless (cellular) telecommunications service on a prepaid service basis (prepaid telephones) whereby a customer purchases the cellular telephone with a set number of minutes available for telecommunications. When the customer exhausts the number of minutes on the prepaid telephone, the customer may purchase additional minutes. The customer does not enter into a contract with the telecommunications provider; there are no service charges after the additional purchase and no monthly bills. Under this notice, the prepaid telephone will be treated as nontaxable service unless the terms of the prepaid telephone service expressly state it is for local-only service.

(2) *Other prepaid cellular telephones*. This section does not address arrangements that permit the holder to purchase various services in addition to telecommunications services. Such services include, but are not limited to, ring tone downloads, music downloads, text messaging, picture messaging, web browsing, game downloads, or screen saver downloads.

(b) *Application of the tax*. Rules similar to the rules for PTCs, as described in section 6 of this notice, apply to prepaid telephones. Thus, the person liable for tax is the person (transferee) that buys the prepaid telephone from the telecommunications provider (carrier) and the carrier is responsible for collecting the tax. Any holder of a prepaid telephone (that is, a person that buys the prepaid telephone other than for resale) is not liable for tax.

(c) *Person eligible to request credit or refund*. The transferee is the person liable for the tax paid on a prepaid telephone and thus generally is the person eligible to request a credit or refund of the tax it paid. The carrier is eligible to request a credit or refund only if it meets the conditions of section 5(d)(4) of Notice 2006–50. The holder is not liable for the tax and thus cannot request a credit or refund.

SECTION 8. CHARGES IN CONNECTION WITH LOCAL-ONLY SERVICE

(a) *Background*. Section 3(b) of Notice 2006–50 defines local-only service as including certain services and facilities provided in connection with local telephone service, even though these services may also be used in connection with long distance service. As examples, the notice cites to Rev. Rul. 72–537, 1972–2 C.B. 574 (telephone amplifier), Rev. Rul. 73–171, 1973–1 C.B. 445 (automatic call distributing equipment), and Rev. Rul. 73–269, 1973–1 C.B. 444 (special telephone).

(b) *Subscriber line charges*. In addition to the examples in paragraph (a) of this section, amounts paid for subscriber line charges, which are described in Rev. Rul. 87–108, 1987–2 C.B. 260, are also amounts paid for local telephone service. This charge may appear on a bill as "Federal Access Charge," "Customer or Subscriber Line Charge," or "Interstate Access Charge."

(c) *Universal service fees*—(1) *Background*. All telecommunications companies that provide interstate and international telecommunications service contribute to the federal Universal Service Fund (USF). Their contributions support four Universal Service programs established and overseen by the Federal Communications Commission (FCC). Some telecommunications companies recover their contribution to the USF directly from their customers by billing them for this charge. The FCC does not require companies to pass on these costs to their customers. Each company makes a business decision about whether and how to recover USF costs. A company that separately states this charge on a bill may call it a "Federal Universal Service Fee" or "Universal Connectivity Fee."

(2) *Application*. Because telecommunications providers charge the USF to their customers in connection with their customers' long distance service, amounts paid for separately stated USF amounts are not amounts paid for local-only service.

SECTION 9. PERSON TO MAKE REQUEST IF TAXPAYER IS NO LONGER IN BUSINESS OR DECEASED

Neither Notice 2006–50 nor this notice create any special rules regarding the person to request a credit or refund of tax for a taxpayer that no longer exists or is deceased. The same rules that apply to requests for credits or refunds of other federal taxes also apply to similar requests of the tax imposed under § 4251. These rules depend upon the facts and circumstances relating to the reasons that the taxpayer no longer exists. The Form 8913 Instructions and Publication 559, *Survivors, Executors, and Administrators*, provide general guidance for taxpayers regarding deceased taxpayers.

SECTION 10. EFFECT OF NOTICE 2006–50 ON STATE AND LOCAL TELECOMMUNICATIONS TAXES

Neither Notice 2006–50 nor this notice affect the ability of state or local governments to impose or collect telecommunication taxes under the respective statutes of those governments.

SECTION 11. NO OBLIGATION OF TELECOMMUNICATIONS PROVIDERS TO SUPPLY RECORDS TO CUSTOMERS

The IRS has been asked to require telecommunications providers to supply their customers with those customers' telecommunications bills for periods after February 28, 2003, and before August 1, 2006. Neither Notice 2006–50 nor this notice requires telecommunications providers to supply billing records to their customers.

SECTION 12. BUSINESS AND NONPROFIT ESTIMATION METHOD

(a) *In general*. This section provides rules for the Business and Nonprofit Estimation Method (EM) that eligible entities may use to determine the amount of their credit or refund for nontaxable service. Eligible entities may, but are not required to, use the EM instead of the actual amount of federal communications excise tax they paid on nontaxable service to calculate the amount of their credit or refund.

(b) *Definitions*. The following definitions apply to this section.

(1) *Eligible entity* means—

(i) Any—

(A) Business entity (including a corporation or partnership);

(B) Trust or estate;

(C) Tax-exempt organization; and

(D) Individual owner of rental property and any self-employed individual (including an independent contractor, sole proprietor, or farmer) but only if the individual (including a married couple filing a joint return) reports gross rental and business income totaling more than $25,000 on his or her 2006 federal income tax return;

(ii) That was in operation during any time from March 1, 2003 through July 31, 2006; and

(iii) That received and paid for telecommunications service that was reflected on bills dated in April 2006 and September 2006.

(2) *Total telephone expenses* means all amounts paid to every telecommunications provider used by the eligible entity for telephone service that were billed after February 28, 2003, and before August 1, 2006. These amounts include, but are not limited to, amounts paid for long distance service, local-only service, bundled service, 900 number service, universal service fees, federal, state, and local taxes. If an eligible entity is billed for telephone and non-telephone services on one bill each month and does not separately track non-telephone services in its books and records, the entire amount of that bill is included in total telephone expenses. An eligible entity may determine the amount of its total telephone expenses by examining its books and records, including, for example, its general ledger, check register, and canceled checks.

(3) *Employee* means any person working for the taxpayer full or part time as reported on the eligible entity's Form 941, *Employer's Quarterly Federal Tax Return*, for the 2nd quarter of 2006, other than any person employed as a household employee, in a non-pay status, on a pension, or an active member of the Armed Forces.

(c) *Using the EM to determine the amount of the credit or refund*—(1) *Determining the federal excise tax as a percentage of the telephone bill*—(i) First, determine the amount of federal communications excise tax on all telephone bills dated in April 2006 and all telephone bills dated in September 2006. The amount is generally separately stated on the bill as "FET" or "federal tax".

(ii) Next, for all the April telephone bills and all the September telephone bills, divide the amount of federal communications excise tax included on the bills by the total telephone expenses on the bills. The resulting amounts are the April and September percentages, respectively.

(iii) Next, subtract the September percentage from the April percentage. For purposes of this notice, this amount is the federal excise tax percentage (FETP).

(2) *Capping the FETP*—(i) Determine the number of employees.

(ii) For taxpayers with 250 or fewer employees, the FETP is capped at 2 percent.

(iii) For taxpayers with more than 250 employees, the FETP is capped at 1 percent.

(d) *Calculating the amount of the credit or refund*—(1) *Records kept on a monthly basis*. If the entity has maintained its telephone expense records on a monthly basis, multiply the FETP amount by the taxpayer's monthly total telephone expenses for each month of the 41 month period from March 2003 through July 2006. The product of this calculation is the taxpayer's credit or refund amount.

(2) *Records kept on an annual basis*. If the entity has maintained its telephone expense records on an annual basis rather than a monthly basis, prorate its annual amount equally to each month of that year. Thus, for example, a taxpayer maintaining annual telephone expense records for 2003 would divide its total telephone expenses by 12. Next, the taxpayer would use that monthly amount to complete the calculations for the credit or refund amount for 2003.

(e) *Actual Amounts*. Use of the EM is optional. Taxpayers may use the actual amounts paid for federal communications excise tax for nontaxable service to determine the amount of their credit or refund.

(f) *Examples*. The following examples illustrate the application of this section.

Example 1—(i) *Facts*. Business A has 250 employees. A's April 2006 telephone bill is $1,700, including federal communications excise tax of $47.60. A's September 2006 telephone bill is $1,600, including federal communications excise tax of $24.00. A's total telephone expenses, for which it does not have monthly records, are as follows:

2003 — $10,800.00

2004 — $16,000.00

2005 — $20,000.00

2006 — $20,571.37.

(ii) *Determining the April and September percentages*. A's April percentage is 2.8 percent (47.60 ÷ 1,700). A's September percentage is 1.5 percent (24 ÷ 1,600).

(iii) *Determining the FETP*. The difference between A's April percentage and September percentage is 1.3 percent (2.8 - 1.5). Thus, the FETP is 1.3 percent.

(iv) *Capping the FETP*. Because A's number of employees does not exceed 250, A's FETP is not capped at 1 percent.

(v) *Prorating*. Because A did not maintain its total telephone expense records by month, it prorates those amounts equally to each month within the March 2003 — July 2006 period for each particular year. For 2003, A divides its total telephone expense of $10,800 by 12 and multiplies that result by 10 (the number of months between March and December). ([10,800 ÷ 12] x 10 = 9,000.) For 2006, A divides its total telephone expense of $20,571.37 by 12 and multiplies that result by 7 (the number of months between January and July). ([20,571.37 ÷ 12] x 7 = 12,000.)

(vi) *Calculating the amount of the credit or refund*. Using the EM, the amount of A's credit or refund is calculated as follows:

2003: $9,000 x .013 = $117 (117÷10 = 11.7) Monthly amount $11.70

2004: $16,000 x .013 = $208 (208÷12 = 17.33) Monthly amount $17.33

2005: $20,000 x .013 = $260 (260÷12 = 21.67) Monthly amount $21.67

2006: $12,000 x .013 = $156 (156÷7 = 22.29) Monthly amount $22.29

(vii) *Reporting the credit or refund amounts on Form 8913*—(A) Because the credit or refund period does not align with the calendar quarters, Form 8913 requires taxpayers to report the credit or refund amounts in 13 three-month intervals and one two-month interval. Thus, A would report credit or refund amounts on Form 8913 as follows:

March, April, May 2003 — $35.10 (11.70 x 3 = 35.10)

June, July, August 2003 — $35.10 (11.70 x 3 = 35.10)

September, October, November 2003 — $35.10 (11.70 x 3 = 35.10)

December 2003, January, February 2004 — $46.36 (11.70 + [17.33 x 2] = 46.36)

March, April, May 2004 — $51.99 (17.33 x 3 = 51.99)

June, July, August 2004 — $51.99 (17.33 x 3 = 51.99)

September, October, November 2004 — $51.99 (17.33 x 3 = 51.99)

December 2004, January, February 2005 — $60.67 (17.33 + [21.67 x 2] = 60.67)

March, April, May 2005 — $65.01 (21.67 x 3 = 65.01)

June, July, August 2005 — $65.01 (21.67 x 3 = 65.01)

September, October, November 2005 — $65.01 (21.67 x 3 = 65.01)

December 2005, January, February 2006 — $66.25 (21.67 + [22.29 x 2] = 66.25)

March, April, May 2006 — $66.87 (22.29 x 3 = 66.87)

June, July 2006 — $44.58 (22.29 x 2 = 44.58)

(B) After determining the amount of credit or refund using the EM, A reports the amounts on Form 8913, and attaches the Form 8913 to A's 2006 federal income tax return.

Example 2. The same facts as *Example 1* except that A has 500 employees. A's FETP is capped at 1 percent. Thus, A must make the same calculation as in *Example 1* to determine the proper amount of A's credit or refund of federal communications excise tax using the FETP of 1 percent, rather than 1.3 percent.

SECTION 13. FORM 1040EZ–T, REQUEST FOR REFUND OF FEDERAL TELEPHONE EXCISE TAX

Individuals who do not have to file a federal income tax return and who meet the conditions for requesting a refund of the federal communications excise tax may file Form 1040EZ–T to request the refund. Individuals requesting a refund of actual amounts of federal communications excise tax paid must complete Form 8913 and attach that form to the Form 1040EZ–T.

SECTION 14. MODIFICATION OF PROVISION REGARDING REQUESTS FOR CREDIT OR REFUND

(a) *Present requirement*. Section 5(g) of Notice 2006–50 provides as follows:

> *Requests that do not follow the provisions of this notice*. Requests that do not follow the provisions of this notice (whether filed before or after its publication)—
>
> (1) Will not be processed to the extent they relate to the tax paid on nontaxable service that was billed after February 28, 2003; and
>
> (2) Will be processed normally to the extent they relate to the tax paid on nontaxable service that was billed before March 1, 2003.

(b) *Reason for modification*. Many of the pending refund claims that were filed on or before May 25, 2006, include refund claims for nontaxable service that was billed before March 1, 2003, and after February 28, 2003. In the interest of sound tax administration and efficiency, the IRS will process all claims for credit or refund that were filed on or before May 25, 2006.

(c) *Revised requirement*. Accordingly, section 5(g) of Notice 2006–50 is modified to read as follows:

> (1) Requests that do not follow the provisions of Notice 2006–50 and that were filed on or before May 25, 2006, will be processed normally.
>
> (2) Requests that were filed on or after May 26, 2006, and do not follow the provisions of Notice 2006–50, will not be processed to the extent they relate to the tax paid on nontaxable service that was billed after February 28, 2003.

SECTION 15. EFFECT ON OTHER DOCUMENTS

Notice 2006–50 is amplified, clarified, and modified.

SECTION 16. DRAFTING INFORMATION

The principal author of this notice is Barbara B. Franklin of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact 202–622–3130 (not a toll-free number).

Weighted Average Interest Rates Update

Notice 2007–12

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

CORPORATE BOND WEIGHTED AVERAGE INTEREST RATE

Sections 412(b)(5)(B)(ii) and 412(l)(7)(C)(i), as amended by the Pension Funding Equity Act of 2004 and by the Pension Protection Act of 2006, provide that the interest rates used to calculate current liability and to determine the required contribution under § 412(l) for plan years beginning in 2004 through 2007 must be within a permissible range based on the weighted average of the rates of interest on amounts invested conservatively in long term investment grade corporate bonds during the 4-year period ending on the last day before the beginning of the plan year.

Notice 2004–34, 2004–1 C.B. 848, provides guidelines for determining the corporate bond weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability. That notice establishes that the corporate bond weighted average is based on the monthly composite corporate bond rate derived from designated corporate bond indices. The methodology for determining the monthly composite corporate bond rate as set forth in Notice 2004–34 continues to apply in determining that rate. See Notice 2006–75, 2006–36 I.R.B. 366.

The composite corporate bond rate for December 2006 is 5.75 percent. Pursuant to Notice 2004–34, the Service has determined this rate as the average of the monthly yields for the included corporate bond indices for that month.

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

For Plan Years Beginning in: Month	Year	Corporate Bond Weighted Average	90% to 110% Permissible Range
January	2007	5.78	5.21 to 5.78

30-YEAR TREASURY SECURITIES INTEREST RATE

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

The rate of interest on 30-year Treasury securities for December 2006 is 4.68 percent. The Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2036.

Drafting Information

The principal authors of this notice are Paul Stern and Tony Montanaro of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 877–829–5500 (a toll-free number), between the hours of 8:30 a.m. and 4:30 p.m. Eastern time, Monday through Friday. Mr. Stern may be reached at 202–283–9703. Mr. Montanaro may be reached at 202–283–9714. The telephone numbers in the preceding sentences are not toll-free.

Modification of the Substantial Assistance Rules

Notice 2007–13

SECTION 1. OVERVIEW

This notice announces that the Treasury Department and the Internal Revenue Service (the IRS) will amend Treas. Reg. § 1.954–4(b)(1)(iv) and (b)(2)(ii) and the examples thereunder, which provide that substantial assistance rendered by a related person or persons to a controlled foreign corporation ("CFC") is included within the definition of foreign base company services income under section 954(e) of the Internal Revenue Code (Code). These amended regulations will limit the types of activities that constitute substantial assistance to certain assistance rendered, directly or indirectly, by a United States person or persons (as the term is defined in section 957(c) of the Code) to a related CFC. Until regulations reflecting these changes are issued, taxpayers may rely on this notice.

In addition, in light of the repeal of the foreign base company shipping income rules under subpart F, this notice confirms that income that previously was foreign base company shipping income will continue to be foreign base company income to the extent that it is within the definition of a remaining category of foreign base company income. This notice also clarifies that Treas. Reg. § 1.954–6, which provides rules addressing foreign base company shipping income, is effective only for purposes of applying the rules for the withdrawal of previously excluded subpart F income from qualified investments under section 955.

SECTION 2. SUBSTANTIAL ASSISTANCE RULES

A. BACKGROUND

Under section 951(a)(1)(A)(i) of the Code, a United States shareholder of a CFC includes in gross income each year its *pro rata* share of the CFC's subpart F income for the taxable year of the CFC which ends with or within such taxable year of the shareholder. Section 952(a)(2) defines the term "subpart F income" to mean, in part, foreign base company income (as defined under section 954).

Section 954(a)(3) of the Code defines "foreign base company income" to include "foreign base company services income" for the taxable year. Section 954(e)(1) defines "foreign base company services income" for purposes of section 954(a)(3) to mean income derived in connection with the performance of services which are performed (1) for, or on behalf of, any related person and (2) outside the country under the laws of which the CFC is created or organized. The statute does not explicitly provide for substantial assistance rules under section 954(e). Those rules are promulgated under the Secretary's authority under section 7805(a) to issue regulations interpreting the term "for, or on behalf of, any related person" under section 954(a)(3).

Treas. Reg. § 1.954–4(b)(1)(iv) defines "services which are performed for, or on behalf of, a related person" to include substantial assistance contributing to the performance of services by a CFC that has been furnished by a related person or persons. Treas. Reg. § 1.954–4(b)(2)(ii) sets forth the rules for the application of the substantial assistance test. Treas. Reg. § 1.954–4(b)(2)(ii)(a) states, in general, that assistance "shall include, but shall not be limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies." Treas. Reg. § 1.954–4(b)(2)(ii)(b) and (c) then provide separate tests depending on whether the assistance provided by the related person or persons is in the form of (1) direction, supervision, services or know-how, or (2) financial assistance, equipment, material or supplies.

Treas. Reg. § 1.954–4(b)(2)(ii)(b) provides that assistance in the form of direction, supervision, services or know-how may be substantial under either a subjective or an objective test. Under the subjective test, assistance in the form of direction, supervision, services or know-how will be considered substantial if the assistance provides the CFC with skills which are a principal element in producing the income from the performance of such services by such CFC (the principal element test). For example, a CFC enters into a contract with an unrelated person to drill an oil well. The technical and supervisory personnel who oversee the drilling of the well are employees of M, a person related to CFC. In such an instance, the services performed by CFC for the unrelated party are considered foreign base company services because the services performed by M substantially assist CFC in the performance of the contract and the services performed by M are a principal element in producing the income from the performance of the drilling contract. *Cf.* Treas. Reg. § 1.954–4(b)(3), Ex. 2.

Alternatively, under the objective test, assistance in the form of direction, supervision, services or know-how may be substantial if the cost to the CFC of the assistance furnished by persons related to the CFC equals 50 percent or more of the total cost to the CFC of performing the services performed by such CFC (the cost test). For these purposes, costs are determined after taking into account adjustments (if any) made under section 482. *See* Treas. Reg. § 1.954–4(b)(2)(ii)(b).

Treas. Reg. § 1.954–4(b)(2)(ii)(c) states, in general, that financial assistance, equipment, material, or supplies furnished by a person related to the CFC shall be considered assistance only in the amount, after taking into account adjustments (if any) made under section 482, by which the consideration actually paid by the CFC to the related person for the purchase or use of such item is less than the arm's length charge for such purchase or use. The total of all such amounts from all related persons is compared with the profits derived by the CFC from the performance of the services to determine whether the related party's contributions qualify as substantial assistance.

Treas. Reg. § 1.954–4(b)(2)(ii)(d) expands on the tests in Treas. Reg. § 1.954–4(b)(2)(ii)(b) and (c) by providing that, even if assistance furnished by a related person or persons to a CFC is not considered substantial under paragraphs (b) or (c) in isolation, it may nevertheless constitute substantial assistance when taken together or in combination with other assistance furnished by a related person or persons to the CFC. Treas. Reg. § 1.954–4(b)(2)(ii)(e) provides that, in applying Treas. Reg. § 1.954–4(b)(2)(ii)(b) and (d), assistance in the form of direction, supervision, services, or know-how shall not be taken into account, unless the assistance so furnished assists the CFC directly in the performance of the services performed. Treas. Reg. § 1.954–4(b)(3) sets forth examples, including examples addressing the application of the substantial assistance test.

B. DISCUSSION

The substantial assistance rules were published as final regulations in 1968 (T.D. 6981, 1968–2 C.B. 314). The purpose of the substantial assistance rules is to treat as foreign base company services income, income received by a CFC from rendering services to an unrelated person where in rendering those services a related person substantially contributes to the CFC's performance of such services in a manner that suggests that the CFC, rather than the related party, entered into the contract to obtain a lower rate of tax on the service income. Since the regulations were published in 1968, there has been a substantial expansion in the reach of the global economy, particularly in the provision of global services. As a result, many of the U.S. multinationals that provide services outside of the United States currently have globally integrated businesses with support capabilities for unrelated customer projects in different geographic locations, largely based on factors such as expertise and cost efficiencies.

For example, a CFC may contract with an unrelated person to provide installation and subsequent repair services. A related CFC, however, is the foreign corporation that provides the repair services. Although the foreign related CFC that is providing the support services will continue to have foreign base company services income to the extent that it performs those services outside of its country of incorporation, it does not seem appropriate in the current global economy to continue to treat the profits of the CFC contracting to furnish services to the unrelated person as foreign base company services income because of the support services provided by a related foreign person. If the substantial assistance regulations are not amended to deal with these types of businesses structures, the regulations may cause taxpayers to change the way they do business or structure their operations in light of the substantial assistance rules, even if such a structure would be less efficient from a business perspective by, for example, requiring a taxpayer to duplicate a full service infrastructure in each country.

The Treasury Department and the IRS, however, remain concerned about the ability of related United States persons to shift profits offshore to CFCs organized in low tax jurisdictions in cases where the related United States person or persons provides so much assistance to the CFC that the CFC cannot be said to be providing services on its own account and thus acting as an independent entity. Accordingly, the Treasury Department and the IRS will revise the regulations to eliminate the substantial assistance rules, except in certain limited instances in which a United States person or persons provide sufficient assistance directly or indirectly to a related CFC.

C. PROPOSED GUIDANCE

The Treasury Department and the IRS will amend Treas. Reg. § 1.954–4(b)(1)(iv) and (b)(2)(ii) and the examples thereunder. Treas. Reg. § 1.954–4(b)(1)(iv) as amended will provide that services performed by a CFC in a case where substantial assistance by a related United States person or persons (as the term is defined in section 957(c) of the Code) contributes to the performance of such service will constitute "services which are performed for, or on behalf of, a related person." Treas. Reg. § 1.954–4(b)(2)(ii) as amended will provide that "substantial assistance" consists of assistance furnished (directly or indirectly) by a related United States person or persons to the CFC if the assistance satisfies an objective cost test. The subjective "principal element" test will no longer apply to determine substantial assistance. For purposes of the objective cost test, the definition of the term "assistance" will include, but will not be limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies provided directly or indirectly by a related United States person to a CFC.

The cost test will be satisfied if the cost to the CFC of the assistance furnished by the related United States person or persons equals or exceeds 80 percent of the total cost to the CFC of performing the services. The term "cost" will be determined after taking into account adjustments, if any, made under section 482 of the Code. Taxpayers may apply the cost test either by demonstrating that the assistance provided, directly or indirectly, by related United States persons is below the 80 percent cost threshold, or, alternatively, by demonstrating that the cost of the services provided by the CFC itself, and/or by a related CFC, is more than 20 percent of the total cost to the CFC of performing the services. For this purpose, services provided by a CFC itself are not assistance provided "indirectly" by a related United States person (or persons). However, employees, officers, or directors of the CFC who are concurrently employees, officers, or directors of a related United States person during a taxable year of the CFC will be considered employees, officers or directors solely of the related United States person for such taxable year for purposes of this notice.

The examples under Treas. Reg. § 1.954–4(b)(2)(ii) will be amended to reflect the amendments to the regulations. The application of the proposed cost test is illustrated by the following examples.

Example 1: USP, a U.S. corporation, wholly owns CFC1 and CFC2, each a foreign corporation. CFC1 enters into a contract with FP, an unrelated foreign person, to design a bridge for FP in Country Y, a foreign country that is not CFC1's country of organization. CFC1 incurs a total of $100x of costs to design the bridge for FP. USP performs supervisory services in Country Y for CFC1 with respect to the contract for which CFC1 pays USP a fee. CFC1 directly performs services related to the performance of that contract that cost CFC1 $15x. CFC2 performs centralized support services related to the performance of that contract in Country X, its country of organization, for which CFC1 pays CFC2 $10x. CFC1 is not treated as receiving substantial assistance in the performance of that contract because more than 20% of the cost of that contract is attributable to services furnished directly by CFC1 or a related CFC (CFC2).

Example 2: USP, a U.S. corporation, wholly owns CFC1 and CFC2, each a foreign corporation. CFC2 enters into a contract with FP, an unrelated person, to design a bridge in Country Y, a foreign country that is not CFC2's country of organization. With respect to the contract with FP, USP performs services in Country Y for CFC1 in the form of design and technical services for which CFC1 pays USP $85x. CFC1 contracts with CFC2 to provide those services and others to CFC2 for $90x. CFC2 uses those services together with services it performs itself that cost CFC2 $10x to design the bridge for FP. Pursuant to the cost test, USP provides substantial assistance to CFC2 in the performance of its contract for FP because USP indirectly furnishes assistance to CFC2 (through CFC1) that exceeds 80 percent of the total cost to CFC2 for performing the contract.

Example 3: USP, a U.S. corporation, wholly owns CFC1 and CFC2, each a foreign corporation. CFC2 enters into a contract with FP, an unrelated person, to design a bridge in Country Y, a foreign country that is not CFC2's country of organization. With respect to the contract with FP, USP performs services in Country Y for CFC1 in the form of design and technical services for which CFC1 pays USP $60x. CFC1 contracts with CFC2 to provide those services and others to CFC2 for $70x. CFC2 uses those services together with services it performs itself that cost CFC2 $30x to design the bridge for FP. CFC2 is not treated as receiving substantial assistance in the performance of that contract because more than 20% of the cost of that contract is attributable to services furnished directly by CFC2.

D. EFFECTIVE DATE

Regulations to be issued incorporating the guidance set forth in this notice will apply to taxable years of foreign corporations beginning on or after January 1, 2007 and to taxable years of United States shareholders in which or with which such taxable years of the foreign corporations end. Until such regulations are issued, taxpayers may rely on this notice.

SECTION 3. FOREIGN BASE COMPANY SHIPPING RULES

Section 415 of the American Jobs Creations Act ("AJCA") repealed sections 954(a)(4) and 954(f) of the Code, (the foreign base company shipping rules). It also made conforming amendments by repealing sections 954(b)(6) and (b)(7) and striking a reference to foreign base company shipping income in section 954(b)(5). These changes are effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. Further, section 415 of the AJCA enacted a special safe harbor for certain leasing activities under section 954(c)(2)(A). The special safe harbor rule has been addressed in a separate published guidance project. *See* Notice 2006–48, 2006–21 I.R.B. 922.

As a result of, and as of the effective date of, the repeal of the foreign base company shipping income rules, Treas. Reg. § 1.954–1(e)(4)(i)(A), which provides that income that qualifies as foreign base company shipping income will not be considered insurance income or income in any other category of foreign base company income, is obsolete and Treas. Reg. § 1.954–6, which prescribes rules for determining foreign base company shipping income, is only effective for purposes of applying the rules for the withdrawal of previously excluded subpart F income from qualified investments under section 955. Accordingly, Treas. Reg. § 1.954–6 will be amended to include new applicability language.

Moreover, the repeal of sections 954(a)(4) and 954(f) of the Code was only intended to eliminate the separate category of foreign base company shipping income. It was not intended to exclude income from subpart F that would otherwise qualify under another category of foreign base company income. Income that might have been described in sections 954(a)(4) and 956(f) before the AJCA still must be tested under the remaining categories of foreign base company income. Consequently, this notice confirms that income described in section 954(f) as it existed before its repeal will continue to constitute subpart F income to the extent that it falls within another category of foreign base company income.

SECTION 4. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on the new substantial assistance rules proposed in this notice. Comments are requested on whether the new rules are appropriately targeted and whether any modifications to the rules should be made before they are promulgated as regulations. In particular, comments are requested on whether the proposed cost test is appropriate for certain industries, and if not, how the rules could be modified or supplemented to properly address those industries while still addressing the Treasury Department's and the IRS' concerns about shifting profits offshore to CFCs organized in low tax jurisdictions. In addition, the Treasury Department and the IRS understand that taxpayers are also concerned with the special rule concerning a guaranty of performance contained in Treas. Reg. § 1.954–4(b)(2)(i). The Treasury Department and the IRS are reviewing this rule, particularly in light of Treas. Reg. § 1.482–9T, and request comments on whether changes to this rule are warranted and, if so, how it should be modified.

Written comments on the issues addressed in this notice may be submitted to the Office of Associate Chief Counsel International, Attention: Notice 2007–13, room 4710, CC:INTL:BR2, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to *Notice.Comments@m1.irscounsel.treas.gov*.

Comments will be available for public inspection and copying.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is Ethan Atticks of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ethan Atticks at (202) 622–3840 (not a toll-free call).

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26 CFR 601.601: Rules and regulations.
(Also Part 1, § 1397E.)

Rev. Proc. 2007–18

SECTION 1. PURPOSE

Pursuant to § 1397E(e)(2) of the Internal Revenue Code, this revenue procedure sets forth the maximum face amount of Qualified Zone Academy Bonds ("Bond" or "Bonds") that may be issued for each State for each of the calendar years 2006 and 2007. For this purpose, "State" includes the District of Columbia and the possessions of the United States.

SECTION 2. BACKGROUND

.01 Section 226 of the Taxpayer Relief Act of 1997, Pub. L. 105–34, 111 Stat. 821 (1997), added § 1397E to the Internal Revenue Code to provide a credit to holders of Bonds under certain circumstances so that the Bonds generally can be issued without discount or interest. Ninety-five percent of Bond proceeds are to be used for qualified purposes, as defined by § 1397E(d)(5), with respect to a qualified zone academy, as defined by § 1397E(d)(4).

.02 Section 1397E(e)(1), as amended by § 107 of the Tax Relief and Health Care Act of 2006, Pub. L. 109–432, 120 Stat. 2922 (2006), provides that the national Bond limitation is $400 million for each of the years 1998, 1999, 2000, 2001, 2002, 2003, 2004, 2005, 2006, and 2007. This amount is to be allocated among the States by the Secretary on the basis of their respective populations below the poverty level (as defined by the Office of Management and Budget) and is to be further allocated by each State to qualified zone academies within the State.

.03 Section 1397E(e)(4), as amended by § 509 of the Tax Relief Extension Act of 1999, Pub. L. 106–170, 113 Stat. 1860 (1999), provides that any carryforward of a limitation amount may be carried forward only to the first 2 years (3 years for carryforwards from 1998 or 1999) following the unused limitation year. For this purpose, a limitation amount shall be treated as used on a first-in, first-out basis.

.04 Rev. Proc. 98–9, 1998–1 C.B. 341; Rev. Proc. 98–57, 1998–2 C.B. 682; Rev. Proc. 2000–10, 2000–1 C.B. 287; Rev. Proc. 2001–14, 2001–1 C.B. 343; Rev. Proc. 2002–25, 2002–1 C.B. 800; Rev. Proc. 2002–72, 2002–2 C.B. 931; Rev. Proc. 2004–61, 2004–2 C.B. 707; and Rev. Proc. 2004–72, 2004–2 C.B. 1033, allocated among the States the national limitation for 1998, 1999, 2000, 2001, 2002, 2003, 2004, and 2005, respectively.

SECTION 3. NATIONAL QUALIFIED ZONE ACADEMY BOND LIMITATION FOR 2006 AND 2007

The national limitation for Bonds for each of the calendar years 2006 and 2007 is $400 million. This amount is allocated among the States as follows:

STATE	MAXIMUM FACE AMOUNT OF BONDS THAT MAY BE ISSUED FOR EACH OF THE CALENDAR YEARS 2006 AND 2007 (thousands of dollars)
Alabama	7,698
Alaska	677
Arizona	9,412
Arkansas	3,921
California	48,404
Colorado	5,440
Connecticut	3,346
Delaware	801
District of Columbia	1,180
Florida	20,271
Georgia	13,322
Hawaii	1,129
Idaho	1,468
Illinois	14,790
Indiana	7,944
Iowa	3,356
Kansas	3,459
Kentucky	6,148
Louisiana	7,677
Maine	1,704
Maryland	5,563
Massachusetts	6,579
Michigan	12,275
Minnesota	4,229
Mississippi	5,861

STATE	MAXIMUM FACE AMOUNT OF BONDS THAT MAY BE ISSUED FOR EACH OF THE CALENDAR YEARS 2006 AND 2007 (thousands of dollars)
Missouri	6,764
Montana	1,314
Nebraska	1,714
Nevada	2,669
New Hampshire	749
New Jersey	6,076
New Mexico	3,562
New York	28,328
North Carolina	11,444
North Dakota	718
Ohio	14,287
Oklahoma	5,573
Oregon	4,475
Pennsylvania	14,082
Rhode Island	1,304
South Carolina	6,425
South Dakota	924
Tennessee	8,950
Texas	37,781
Utah	2,381
Vermont	482
Virginia	7,020
Washington	6,528
West Virginia	2,833
Wisconsin	5,676
Wyoming	554
American Samoa	363
Guam	397
Northern Marianas	380
Puerto Rico	19,230
Virgin Islands	363
Total	$400,000

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for Bonds issued pursuant to the national limitation for calendar year 2006 on or after January 1, 2006, and Bonds issued pursuant to the national limitation for calendar year 2007 on or after January 1, 2007.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is David White of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue procedure, contact Mr. White at (202) 622–3980 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Corporate Reorganizations; Distributions Under Sections 368(a)(1)(D) and 354(b)(1)(B)

REG–125632–06

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9303) that provide guidance regarding the qualification of certain transactions as reorganizations described in section 368(a)(1)(D) where no stock and/or securities of the acquiring corporation is issued and distributed in the transaction. These regulations affect corporations engaging in such transactions and their shareholders. The text of those regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by March 19, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–125632–06), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered to CC:PA:LPD:PR (REG–147144–06), Courier Desk, Internal Revenue Service, Crystal Mall 4, 1901 South Bell Street, Arlington, Virginia, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–125632–06).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Bruce A. Decker, (202) 622–7550; concerning submission of comments, requests for a public hearing, and/or a publication and regulations specialist, Treena Garrett, (202) 622–7180.

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in this issue of the Bulletin amend 26 CFR part 1. The temporary regulations provide guidance on circumstances where the distribution of stock and/or securities under section 354(b)(1)(B) will be deemed satisfied in the absence of an actual issuance of stock and/or securities pursuant to a reorganization described in section 368(a)(1)(D). The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Explanation of Provisions

These temporary regulations provide guidance regarding the circumstances in which the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) is deemed satisfied despite the fact that no stock and/or securities are actually issued in a transaction otherwise described in section 368(a)(1)(D). These regulations will affect certain cash sales of assets between two corporations that have the same direct or indirect shareholders or a *de minimis* variation in shareholder identity and proportionality.

Special Analyses

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

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. The IRS and Treasury Department request comments on several issues relating to acquisitive reorganizations described in section 368(a)(1)(D). Specifically, the IRS and Treasury Department request comments on whether the meaningless gesture doctrine is inconsistent with the distribution requirement in sections 368(a)(1)(D) and 354(b)(1)(B), especially in situations in which the cash consideration received equals the full fair market value of the property transferred such that there is no missing consideration for which the nominal share of stock deemed received and distributed could substitute. The IRS and Treasury Department also request comments on the extent, if any, to which the continuity of interest requirement should apply to a reorganization described in section 368(a)(1)(D). The IRS and Treasury Department request comments on whether these temporary regulations should apply when the parties to the reorganization are members of a consolidated group. Finally, the IRS and Treasury Department request comments on the continued vitality of various liquidation-reincorporation authorities after the enactment of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085 (1986)). All comments will be available for public inspection and copying. A public hearing will 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 Bruce A. Decker, Office of Associate Chief Counsel (Corporate).

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.368–2 is amended by revising paragraph (l) to read as follows:

§1.368–2 Definition of terms.

* * * * *

(l) [The text of this proposed amendment to §1.368–2(l) is the same as the text of §1.368–2T(l)(1) through (l)(4)(i) published elsewhere in this issue of the Bulletin.

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

(Filed by the Office of the Federal Register on December 18, 2006, 8:45 a.m., and published in the issue of the Federal Register for December 18, 2006, 71 F.R. 75898)

Railroad Track Maintenance Credit; Correction

Announcement 2007–8

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to temporary regulations.

SUMMARY: This document contains corrections to temporary regulations (T.D. 9286, 2006–43 I.R.B. 750) that were published in the **Federal Register** on Friday, September 8, 2006 (71 FR 53009) providing rules for claiming the railroad track maintenance credit under section 45G of the Internal Revenue Code for qualified railroad track maintenance expenditures paid or incurred by a Class II railroad or Class III railroad and other eligible taxpayers during the taxable year.

DATES: This correction is effective September 8, 2006.

FOR FURTHER INFORMATION CONTACT: Winston H. Douglas, (202) 622–3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The correction notice that is the subject of this document is under section 45G of the Internal Revenue Code.

Need for Correction

As published, temporary regulations (T.D. 9286) contain errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the temporary regulations (T.D. 9286), which was the subject of FR Doc. E6–14858, is corrected as follows:

1. On page 53010, column 1, in the preamble, under the paragraph heading "*General Overview*", first and second lines from the bottom of the second paragraph, the language "assigned to such person by such a railroad." is corrected to read "assigned to such person by a Class II railroad or a Class III railroad.".

2. On page 53010, column 2, in the preamble, under the paragraph heading "*Scope*", first paragraph of the column, last line of the paragraph, the language "of controlled groups under section 45G." is corrected to read "of controlled groups under section 45G with respect to the RTMC.".

3. On page 53010, column 2, in the preamble, under the paragraph heading "*Eligible Taxpayer*", fourth line of the first paragraph, the language "defined in the temporary regulations as:" is corrected to read "defined as:".

4. On page 53010, column 2, in the preamble, under the paragraph heading "*Eligible Taxpayer*", third line from the bottom of the first paragraph, the language "railroad track assigned to the person for" is corrected to read "railroad track assigned to the taxpayer for".

5. On page 53010, column 2, in the preamble, under the paragraph heading "*Eligible Taxpayer*", second through the sixth line from the bottom of the second paragraph, the language "Price Index)). 49 CFR part 1201, subpart A, §1–1(a). In general, Class III railroads have annual carrier operating revenues of $20 million or less after applying the railroad revenue deflator formula. 49" is corrected to read "Price Index)). See 49 CFR part 1201, subpart A, §1–1(a). In general, Class III railroads have annual carrier operating revenues of $20 million or less after applying the railroad revenue deflator formula. See 49".

6. On page 53010, column 3, in the preamble, under the paragraph heading "*Eligible Taxpayer*", second paragraph of the column, tenth to seventeenth lines, the language "services are the transport of freight by rail, the loading and unloading of freight transported by rail, locomotive leasing or rental, and maintenance of a railroad's right-of-way (including vegetation control). Examples of services that are not railroad-related services are general business services," is corrected to read "services include the transport of freight by rail, the loading and unloading of freight transported by rail, locomotive leasing or rental, and maintenance of a railroad's right-of-way (including vegetation control). Examples of services that are not railroad-related services include general business services,".

7. On page 53011, column 1, in the preamble, under the paragraph heading "*Determination of QRTME Paid or Incurred*", second paragraph, third and fourth lines, the language "to a taxpayer using an accrual method of accounting. In this case, paid or" is corrected to read "to taxpayers using an accrual method of accounting. For such taxpayers, paid or".

8. On page 53011, column 1, in the preamble, under the paragraph heading "*Determination of QRTME Paid or Incurred*", second paragraph, fifteenth to twentieth lines, the language "any such expenditures. The temporary regulations provide that reimbursements may consist of amounts paid either directly or indirectly to the taxpayer. Examples of indirect reimbursements are discounted freight shipping rates," is corrected to read "any expenditures that would otherwise qualify as QRTME. The temporary regulations provide that reimbursements may consist of amounts paid either directly or indirectly to the taxpayer. Examples of indirect reimbursements include discounted freight shipping rates,".

9. On page 53011, column 1, in the preamble, under the paragraph heading "*Determination of QRTME Paid or Incurred*", third paragraph, first line, the language

"If an eligible taxpayer (assignee) pays" is corrected to read "The IRS and Treasury believe that the statute is intended to allow suppliers and shippers to claim the credit for providing the funding for the QRTME performed on railroad track owned by, or leased to, a Class II railroad or Class III railroad. However, the suppliers and shippers may not have the necessary expertise to perform the repairs and improvements. The IRS and Treasury believe that these eligible taxpayers should be able to claim the credit for providing the funding to the extent that the Class II railroads and Class III railroads use such funding to perform the repairs and improvements to the track. Therefore, if an eligible taxpayer (assignee) pays".

10. On page 53011, column 1, in the preamble, under the paragraph heading "*Determination of QRTME Paid or Incurred*", third paragraph, fifth line from the bottom of the column, the language "paragraph, this QRTME would be" is corrected to read "paragraph, QRTME would be".

11. On page 53011, column 2, in the preamble, under the paragraph heading "*Assignment of Railroad Track Miles*", first paragraph, first through fifth lines, the language "For purposes of section 45G, the temporary regulations provide that an assignment of a mile of railroad track is not a legal transfer of title, but merely a designation. This designation must be" is corrected to read "The temporary regulations provide that an assignment of a mile of railroad track is not a legal transfer of title, but merely a designation made solely for purposes of section 45G. This designation must be".

12. On page 53011, column 2, in the preamble, under the paragraph heading "*Assignment of Railroad Track Miles*", second paragraph, fifth line, the language "track. Thus, if a Class II railroad or Class" is corrected to read "track. If a Class II railroad or Class".

13. On page 53011, column 2, in the preamble, under the paragraph heading "*Assignment of Railroad Track Miles*", fourth paragraph, second line, the language "that a taxpayer must file Form 8900," is corrected to read "that a taxpayer file Form 8900,".

14. On page 53011, column 3, in the preamble, last paragraph of the column, first line, the language "The temporary regulations also" is corrected to read "The temporary regulations".

15. On page 53012, column 1, in the preamble, first paragraph of the column, first line, the language "assignment is properly reported." is corrected to read "assignment is reported.".

16. On page 53012, column 1, in the preamble, under the paragraph heading "*Special Rules*", first paragraph, second through fourth lines from the bottom of the paragraph, the language "structure (railroad track, roadbed, bridges, and related track structures) and intangible assets to which the" is corrected to read "structure and intangible assets to which the".

17. On page 53012, column 1, in the preamble, under the paragraph heading "*Special Rules*", second paragraph, sixth line, the language "of the RTMC allowable. This reduction" is corrected to read "of the RTMC allowable. The basis reduction".

18. On page 53012, column 1, in the preamble, under the paragraph heading "*Special Rules*", third paragraph, first line, the language "The temporary regulations also" is corrected to read "The temporary regulations do not".

19. On page 53012, column 2, in the preamble, under the paragraph heading "*Special Rules*", first paragraph of the column, fourth line to the last of the paragraph, the language "legislative history does not refer to, any exception to this rule. Accordingly, pursuant to section 61 and the regulations under section 61, the owner of the tangible assets (for example, railroad track and roadbed) with respect to which the QRTME is paid or incurred by another person that does not have a depreciable interest in those assets has gross income in the amount of that QRTME. However, the application of section 61 to QRTME paid or incurred with respect to eligible railroad track that is leased by a Class II railroad or Class III railroad raises a question as to under what circumstances the owner or lessee should recognize gross income with respect to QRTME. The IRS and Treasury Department request comments on this issue." is replaced to read "legislative history does not refer to, any exception to this rule for an owner of tangible assets (for example, railroad track and roadbed) for the value of the repairs or improvements to such assets with respect to which QRTME is paid or incurred by another person that does not have a depreciable interest in such assets."

LaNita Van Dyke,
Chief, Publications and Regulations Branch,
Legal Processing Division,
Associate Chief Counsel
(Procedure and Administration).

(Filed by the Office of the Federal Register on December 7, 2006, 8:45 a.m., and published in the issue of the Federal Register for December 8, 2006, 71 F.R. 71045)

Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles; Stewardship Expense; Correction

Announcement 2007–9

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendments.

SUMMARY: This document contains corrections to final and temporary regulations (T.D. 9278, 2006–34 I.R.B. 256) that was published in the **Federal Register** on Friday, August 4, 2006 (71 FR 44466) regarding the treatment of controlled services transactions under section 482 and the allocation of income from intangibles, in particular with respect to contributions by a controlled party to the value of an intangible owned by another controlled party. This document also contains corrections to final and temporary regulations that modify the regulations under section 861 concerning stewardship expenses to be consistent with the changes made to the regulations under section 482.

EFFECTIVE DATE: The amendments are effective on January 1, 2007.

FOR FURTHER INFORMATION CONTACT: Thomas A. Vidano, (202) 435–5265, or Carol B. Tan (202) 435–5159, for matters relating to section 482, and David F. Bergkuist, (202) 622–3850, for matters relating to stewardship expenses (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The final and temporary regulations that are the subject of these corrections are under sections 482 and 861 of the Internal Revenue Code.

Need for Correction

As published, the final and temporary regulations (T.D. 9278) contains errors that may prove to be misleading and are in need of clarification.

* * * * *

Correction of Publication

Accordingly, 26 CFR part 1 is corrected by making the following correcting amendments:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.482–0T is amended by removing the entries for paragraphs (i)(1) through (i)(10), (j)(1), (j)(2) and (j)(3) from §1.482–1T.

Par. 3. Section 1.482–1 is amended by revising paragraph (i) introductory text to read as follows:

§1.482–1 Allocation of income and deductions among taxpayers.

* * * * *

(i) [Reserved]. For further guidance, see §1.482–1T(i) introductory text.

* * * * *

Par. 4. Section 1.482–1T is amended as follows:

1. Paragraphs (i)(1) through (i)(10) are added and reserved.

2. Paragraphs (j)(1) through (j)(5) are amended by adding "§" before the language "1.482–1(j)(1)".

The addition reads as follows:

§1.482–1T Allocation of income and deductions among taxpayers (temporary).

* * * * *

(i)(1) through (i)(10) [Reserved]. For further guidance, see §1.482–1(i)(1) through (i)(10).

* * * * *

Par. 5. Section 1.482–8T is amended by revising paragraph (b) *Example 12.* (iv), second sentence to read as follows:

§1.482–8T Example of the best method rule (temporary).

* * * * *

(b) * * *

Example 12. (i) * * *

(iv) * * * USP contributed the long-term endorsement contracts with professional athletes. * * *

* * * * *

Par. 6. Section 1.482–9T is amended as follows:

1. Paragraph (b)(6), *Example 22.* (vi), introductory text is revised.

2. Paragraph (g)(2), *Example 2.* (iv), fifth sentence is revised.

3. Paragraph (i)(2) is revised.

4. Paragraph (i)(5), *Example 1.* (iii), first sentence is revised.

5. Paragraph (i)(5), *Example 3.* (ii), first sentence is revised.

6. Paragraph (l)(5), *Example 20.* (i), second sentence is revised.

7. Paragraph (m)(5), *Example 1.* (ii), fourth sentence is revised.

The revisions read as follows:

§1.482–9T Methods to determine taxable income in connection with a controlled services transaction (temporary).

* * * * *

(b) * * *

(6) * * *

Example 22. (i) * * *

(vi) In contrast, if aggregated services AB were allocated by reference to the total U.S. dollar value of sales to uncontrolled parties (trade sales) by each company, the following results would obtain:

* * * * *

(g) * * *

(2) * * *

Example 2. * * *

(iv) * * * In the bid on the Country 2 contract for Level 1 waste remediation, Company B proposes to use a multidisciplinary team of specialists from Company A and Company B. * * *

* * * * *

(i) * * *

(2) * * * For purposes of this paragraph (i), an arrangement will be treated as a contingent-payment arrangement if it meets all of the requirements in paragraph (i)(2)(i) of this section and is consistent with the economic substance and conduct requirement in paragraph (i)(2)(ii) of this section.

* * * * *

(5) * * *

Example 1. (i) * * *

(iii) The years under examination are years 6 through 9. ***

* * * * *

Example 3. (i) * * *

(ii) The years under examination are years 6 through 9. * * *

* * * * *

(l) * * *

(5) * * *

Example 20. (i) * * * Y, a Country B corporation, is a distribution and marketing company that also performs clinical trials for X in Country B. * * *

* * * * *

(m) * * *

(5) * * *

Example 1. (i) * * *

(ii) * * * The comparable profits method may provide the most reliable measure of an arm's length result if uncontrolled parties are identified that perform similar, combined functions of maintaining and providing spare parts for similar equipment. * * *

* * * * *

Par. 7. Section 1.861–8T is amended as follows:

1. Paragraph (b)(3) is revised.

2. Paragraph (g), paragraph (i) following *Example 30.* (i)(C) is redesignated as paragraph (ii) and the paragraph designation for *Example 30.* (i)(C) is removed.

3. Paragraph (h)(1), first three sentences are revised.

4. Paragraph (h)(3) is revised.

The revisions read as follows:

§1.861–8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

* * * * *

(b) * * *

(3) *Supportive functions*. Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on

some reasonable basis directly to activities or property which generate, have generated or could reasonably be expected to generate gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) to expenses other than expenses attributable to stewardship activities, see *Examples 19* through *21* of paragraph (g) of this section. See paragraph (e)(4)(ii) of this section for the allocation and apportionment of deductions attributable to stewardship expenses. However, supportive deductions that are described in §1.861–14T(e)(3) shall be allocated and apportioned in accordance with the rules of §1.861–14T and shall not be allocated and apportioned by reference only to the gross income of a single member of an affiliated group of corporations as defined in §1.861–14T(d).

* * * * *

(h) * * * (1) * * * In general, the rules of this section, as well as the rules of §§1.861–9T, 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–14T apply for taxable years beginning after December 31, 1986, except for paragraphs (a)(5)(ii), (b)(3), (e)(4), (f)(4)(i), and paragraph (g) *Example 17*, *Example 18*, and *Example 30* of this section, which are generally applicable for taxable years beginning after December 31, 2006. Also, see §§1.861–8(e)(12)(iv) and 1.861–14(e)(6) for rules concerning the allocation and apportionment of deductions for charitable contributions. In the case of corporate taxpayers, transition rules set forth in §1.861–13T provide for the gradual phase-in of certain provisions of this and the foregoing sections. * * *

(3) *Expiration date*. The applicability of the paragraphs (a)(5)(ii), (b)(3), (e)(4), (f)(4)(i), and paragraph (g) *Example 17*, *Example 18*, and *Example 30* of this section, expires on or before July 31, 2009.

Par. 8. Section 1.6662–6T is amended by revising paragraph (d)(2)(ii)(B), first sentence to read as follows:

§1.6662–6T Transactions between parties described in section 482 and net section 482 transfer price adjustments (temporary).

* * * * *

(d)(2)(ii)(B) A taxpayer's selection of the services cost method for certain services, described in §1.482–9T(b), and its application of that method to a controlled services transaction will be considered reasonable for purposes of the specified method requirement only if the taxpayer reasonably allocated and apportioned costs in accordance with §1.482–9T(k), reasonably concluded that the controlled services transaction meets the conditions of §1.482–9T(b)(3), and reasonably concluded that the controlled services transaction is not described in §1.482–9T(b)(2). * * *

* * * * *

Cynthia Grigsby,
Senior Federal Register Liaison Officer,
Legal Processing Division,
Associate Chief Counsel
(Procedure and Administration).

(Filed by the Office of the Federal Register on December 21, 2006, 8:45 a.m., and published in the issue of the Federal Register for December 22, 2006, 71 F.R. 76902)

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 2006–27 through 2006–52 is in Internal Revenue Bulletin 2006–52, dated December 26, 2006.

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2006–27 through 2006–52 is in Internal Revenue Bulletin 2006–52, dated December 26, 2006.

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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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