Internal Revenue
bulletin

Bulletin No. 2008-25
June 23, 2008

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. 2008–30, page 1156.

Accounting methods; contributions to capital; public utility. This ruling provides that a public utility's change from treating certain payments received from customers as nontaxable contributions to capital under section 118(c) of the Code to treating the payments as taxable customer connection fees is a change in method of accounting under sections 446(e) and 481.

T.D. 9399, page 1157.

Final regulations under section 7874 of the Code provide for determining whether a foreign corporation is a surrogate foreign corporation when the foreign corporation is part of an expanded affiliated group.

REG–106897–08, page 1175.

Proposed regulations under section 274(i) of the Code provide guidance relating to qualified nonpersonal use vehicles. The regulations also add clearly marked public safety officer vehicles as a new type of qualified nonpersonal use vehicle.

Notice 2008–51, page 1163.

This notice provides guidance on qualified Health Savings Account (HSA) funding distributions from an Individual Retirement Account (IRA) to an HSA.

Notice 2008–52, page 1166.

This notice provides guidance on the contribution limits for Health Savings Accounts (HSAs) for 2007 and later years. Notices 2004–2 and 2004–50 modified.

EXEMPT ORGANIZATIONS

Announcement 2008–55, page 1178.

The IRS has revoked its determination that Texas Reinvestment Corporation II of San Antonio, TX; Zebra Project, Inc., of Atlanta, GA; Alliance for Science Health and Environment, Inc., of Melbourne Beach, FL; Gymfest, Inc., of West Seneca, NY; Estrellas Nacientes, Inc., of New York, NY; Dunardry Heritage Association of Rickman, TN; and Students Are For Education, Inc., of Tallahassee, FL, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

GIFT TAX

REG–143716–04, page 1170.

Proposed regulations under section 7477 of the Code provide rules for determining whether a donor may petition the Tax Court for a declaratory judgment with respect to the value of a gift, for gift tax purposes, where the gift does not generate any current gift tax liability. A public hearing is scheduled for October 16, 2008.

ADMINISTRATIVE

REG–143716–04, page 1170.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

REG–106897–08, page 1175.

Proposed regulations under section 274(i) of the Code provide guidance relating to qualified nonpersonal use vehicles. The regulations also add clearly marked public safety officer vehicles as a new type of qualified nonpersonal use vehicle.

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 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.
(Also § 118.)

Accounting methods; contributions to capital; public utility. This ruling provides that a public utility's change from treating certain payments received from customers as nontaxable contributions to capital under section 118(c) of the Code to treating the payments as taxable customer connection fees is a change in method of accounting under sections 446(e) and 481.

Rev. Rul. 2008–30

ISSUE

Does the change from (1) treating certain payments received from customers as contributions to capital under § 118(c) of the Internal Revenue Code to (2) treating the payments as taxable customer connection fees constitute a change in method of accounting within the meaning of §§ 446 and 481 and the regulations thereunder?

FACTS

U corporation is a regulated public utility that operates and maintains sanitary sewer lines and sewerage disposal plants. *U* charges a "customer connection fee" to certain customers when *U* must build lines to extend its existing infrastructure to the customer in order to start sewerage disposal services. These customer connection fees finance *U*'s construction of sewer line extensions to the customer.

In Years 1, 2 and 3, *U* treats the customer connection fees as contributions in aid of construction (CIACs) within the meaning of § 118(c) and excludes the customer connection fees from *U*'s gross income as contributions to capital under § 118(a). As required by § 118(c)(4), *U* takes an adjusted basis of zero in the sewer line extensions that it constructs and finances with the customer connection fees.

In Year 4, *U* concludes that its customer connection fees are properly includible in gross income because the exclusion provided by § 118(c) does not apply. Beginning in Year 4, *U* includes customer connection fees in gross income and capitalizes the cost of the sewer line extensions constructed and financed with these fees. *U* claims depreciation deductions for the capitalized cost of these sewer line extensions over the recovery period prescribed under § 168.

LAW

Section 61(a) and the regulations thereunder define gross income to mean, except as otherwise provided, all income from whatever source derived.

Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

Section 118(c)(1) provides that the term "contribution to the capital of the taxpayer" includes certain amounts received by regulated public water and sewerage disposal utilities as a CIAC. Under § 118(c)(4), the adjusted basis of any property acquired with a CIAC that is excludable from gross income under § 118(c) is zero.

Section 446(e) requires a taxpayer who changes its method of accounting to secure the consent of the Commissioner before computing its taxable income under the new method. Under § 1.446–1(e)(2)(ii)(*a*) of the Income Tax Regulations, a change in a method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in the overall plan of accounting. A material item is any item the treatment of which affects the proper time for including income or taking a deduction. § 1.446–1(e)(2)(ii)(*a*). The key characteristic of a material item "is that it determines the timing of income or deductions." *Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781, 798 (11th Cir. 1984).

The relevant question is generally whether the treatment of the item permanently changes the amount of taxable income over the taxpayer's lifetime. If the treatment does not permanently affect the taxpayer's lifetime taxable income, but does or could change the taxable year in which taxable income is reported, the treatment affects timing and is therefore a method of accounting. *See Knight-Ridder Newspapers, Inc.*, 743 F.2d at 799; *Peoples Bank & Trust Co. v. Commissioner*, 415 F.2d 1341, 1344 (7th Cir. 1969); *Primo Pants Co. v. Commissioner*, 78 T.C. 705, 723 (1982); Rev. Proc. 91–31, 1991–1 C.B. 566, § 3.02.

A change in method of accounting does not include an adjustment of any item of income or deduction that does not affect the proper time for including the item in income or taking a deduction. § 1.446–1(e)(2)(ii)(*b*). For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and corrections of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. *Id.*

Section 481(a) requires a taxpayer to take into account any adjustment to taxable income necessary to prevent amounts from being duplicated or omitted as a result of a change in method of accounting.

In *Saline Sewer Co. v. Commissioner*, T.C. Memo. 1992–236, the Tax Court held that a change from excluding customer connection fees from gross income, as nontaxable CIACs under § 118, to including the customer connection fees in gross income was not a change in method of accounting because, according to the court, "no timing issue [wa]s involved." 63 T.C.M. (CCH) 2834. The taxpayer in *Saline Sewer* treated customer connection fees as an excludable CIAC under § 118, which required an adjusted basis of zero in the improvements constructed with these fees. Upon examination of the taxpayer's income tax return, the Service determined that the customer connection fees did not qualify for the exclusion under § 118. The Service proposed to change the taxpayer's method of accounting to include customer connection fees in income and increase the depreciable basis of the improvements constructed with these fees.

In reaching its conclusion that the change imposed by the Service did not constitute a change in method of accounting, the court analyzed the receipt of the

customer connection fees independently from the effect on depreciable basis of the improvements constructed with those fees. The court concluded that a change from excluding customer connection fees from income to including them in income gives rise to a permanent difference in lifetime income, not a timing difference, and therefore is not a change in accounting method. Similarly, the court concluded that a change in the depreciable basis of the improvements results in a permanent difference in the amount of depreciation deductions allowed, and that this change is not a change in accounting method. The court did not consider the effect of the combined changes in income, basis, and depreciation on the taxpayer's lifetime taxable income. *See also Florida Progress Corp. v. United States*, 156 F.Supp.2d 1265, 1276 (M.D. Fla. 1999) (relying upon *Saline Sewer* and holding that the change in treatment of customer connection fees was not a change in method of accounting), *aff'd per curiam on other issues*, 264 F.3d 1313 (11th Cir. 2001).

ANALYSIS

Whether *U*'s change to the treatment of its customer connection fees is a change in method of accounting depends upon whether the change permanently affects *U*'s lifetime taxable income. If *U*'s change has no effect on its lifetime taxable income, but affects only the timing of that income, then it is a change in method of accounting. "Taxable income," as defined in § 63, means gross income minus allowable deductions. Therefore, an analysis of the effect of *U*'s change on lifetime taxable income must consider the effect on both income and deductions.

Section 118 affects both the gross income and the deduction of CIACs qualifying under § 118(c). Section 118(c)(1) excludes the customer connection fees from gross income, and § 118(c)(4) mandates a depreciable basis of zero for the improvements constructed with these customer connection fees, resulting in no depreciation or other deduction. The net effect of § 118(c) is to deny depreciation deductions for infrastructure developed with funds previously excluded from income. *See* Small Business Job Protection Act of 1996, H.R. Rep. No. 104–737, at 316 (1996) (indicating that the designation "contributions in aid of construction" impacts both gross income and basis).

U's lifetime taxable income with respect to its customer connection fees is the same whether those fees are treated as (1) gross income followed by allowable depreciation deductions or (2) nontaxable CIACs resulting in zero basis and no depreciation deductions. Under its existing treatment, *U* excludes the customer connection fees from gross income and can take no depreciation deductions because the customer connection fees are not included in the depreciable basis of the assets constructed with the fees. *See* § 118(c). Under its contemplated treatment, *U* includes the customer connection fees in gross income and may take depreciation deductions (over the assets' recovery periods) because the customer connection fees create depreciable basis in the assets constructed with the fees. Thus, *U*'s lifetime taxable income will be the same under either treatment because there are corresponding and offsetting changes in *U*'s gross income and deductions. Accordingly, *U*'s change from treating customer connection fees as nontaxable CIACs under § 118(c) to treating the payments as includible in gross income constitutes a change in method of accounting within the meaning of §§ 446 and 481 and the regulations thereunder. *See Johnson v. Commissioner*, 108 T.C. 448, 495 (1997) (both income and related offsetting deductions are considered when determining if lifetime income is affected), *aff'd in part, rev'd in part,* 184 F.3d 786, 790 (8th Cir. 1999); *Rankin v. Commissioner*, 138 F.3d 1286, 1289 (9th Cir. 1998) (combined effect of current-year deductions and offsetting income in future years must be considered in determining whether a change in method of accounting occurs); *see also* Rev. Proc. 2002–9, 2002–1 C.B. 327, §§ 1.01, 1A.01 of the APPENDIX.

The legislative history of § 118 supports this conclusion. When originally enacted, § 118 functioned much as it does today: it allowed certain regulated public utilities to exclude CIACs from gross income (and required a reduction in depreciable basis). The legislative history is clear that Congress viewed the exclusion as a method of accounting. *See* S. Rept. No. 94–938, at 436 (1976) ("If a taxpayer wishes to change its present practice of treating contributions in aid of construction to a practice which is consistent with this provision, such change constitutes a change in method of accounting"). The exclusion for CIACs was repealed but reenacted in 1996. In reenacting the exclusion, Congress did not address or revisit the question of whether a change to or from § 118 treatment is a change in method of accounting. *See* H.R. Rep. No. 104–737, at 316 (1996).

HOLDING

A change from treating certain payments received from customers as nontaxable contributions to capital under § 118(c) to treating the payments as taxable customer connection fees is a change in method of accounting under §§ 446 and 481. Similarly, a change from treating customer connection fees as taxable customer connection fees to nontaxable contributions to capital under § 118(c) constitutes a change in method of accounting under §§ 446 and 481.

For the foregoing reasons, the Service does not acquiesce in the holdings on this issue in *Saline Sewer Co. v. Commissioner*, T.C. Memo. 1992–236, and *Florida Progress Corp. v. United States*, 156 F.Supp.2d 1265 (M.D. Fla. 1999).

DRAFTING INFORMATION

The principal author of this revenue ruling is Karla M. Meola of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Ms. Meola at (202) 622–4930 (not a toll-free call).

Section 7874.—Rules Relating to Expatriated Entities and Their Foreign Parents

26 CFR 1.7874–1: Disregard of affiliate-owned stock.

T.D. 9399

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Section 7874 for Determining the Ownership

Percentage in the Case of Expanded Affiliated Groups

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations under section 7874 of the Internal Revenue Code (Code) relating to the disregard of certain affiliate-owned stock in determining whether a corporation is a surrogate foreign corporation under section 7874(a)(2)(B) of the Code.

DATES: *Effective Date:* These regulations are effective on May 20, 2008.

Applicability Date: For the date of applicability, see §1.7874–1(g).

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

SUPPLEMENTARY INFORMATION:

Background

Section 7874 provides rules for expatriated entities and their surrogate foreign corporations. An expatriated entity is defined in section 7874(a)(2)(A) as a domestic corporation or partnership with respect to which a foreign corporation is a surrogate foreign corporation, and any U.S. person related (within the meaning of section 267(b) or section 707(b)(1)) to such domestic corporation or partnership. Generally, a foreign corporation is a surrogate foreign corporation under section 7874(a)(2)(B) if, pursuant to a plan or a series of related transactions, certain conditions are met. One such condition depends on the percentage of owner continuity in the foreign corporation after the acquisition. This condition is satisfied if, after the acquisition, at least 60 percent of the stock (by vote or value) of the foreign corporation is held (in the case of an acquisition with respect to a domestic corporation) by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, or (in the case of an acquisition with respect to a domestic partnership) by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership. See section 7874(a)(2)(B)(ii).

The treatment of expatriated entities and surrogate foreign corporations varies depending on this percentage (ownership fraction). If the ownership fraction is 80 percent or more, the surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code. If the ownership fraction is 60 percent or more (but less than 80 percent), the surrogate foreign corporation is treated as a foreign corporation, but certain income or gain recognized by the expatriated entity generally cannot be offset by net operating losses or credits from the first date properties are acquired pursuant to the plan through the end of the 10-year period following the completion of the acquisition.

Section 7874(c)(2)(A) provides that stock held by members of the "expanded affiliated group" which includes the foreign corporation is not taken into account for purposes of the ownership fraction (affiliate-owned stock rule). Section 7874(c)(1) defines the term expanded affiliated group (EAG) as an affiliated group defined in section 1504(a), but without regard to the exclusion of foreign corporations in section 1504(b)(3) and with a reduction of the 80 percent ownership threshold of section 1504(a) to a more-than-50 percent threshold.

Section 7874(g) provides that "[t]he Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through . . . the use of related persons, pass-through or other noncorporate entities, or other intermediaries . . . ." Section 7874(c)(6) provides that "[t]he Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations . . . to treat stock as not stock."

On December 28, 2005, a temporary regulation (T.D. 9238, 2006–1 C.B. 408) was published in the Federal Register (70 FR 76685) that related to the disregard of affiliate-owned stock under section 7874(c)(2)(A). A notice of proposed rulemaking (REG–143244–05, 2006–1 C.B. 419) cross-referencing the temporary regulation was published in the Federal Register for the same day (70 FR 76732). No public hearing was requested or held. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulation is adopted, as amended by this Treasury decision, as final, and the corresponding temporary regulation is removed. The revisions are discussed below.

Summary of Comments and Revisions

A. *Temporary and Proposed Regulations*

Treasury regulation §1.7874–1T provides guidance under the affiliated-owned stock rule. Generally, §1.7874–1T provides that stock owned by members of an EAG is excluded from both the numerator and denominator of the ownership fraction. However, affiliate-owned stock is excluded from the numerator of the ownership fraction, but is included in the denominator of the ownership fraction, in two instances: (1) certain transactions occurring as part of an internal group restructuring involving a domestic entity; and (2) certain acquisitive business transactions between unrelated parties where the former shareholders or partners of the domestic entity have a minority interest in the acquired properties after the acquisition.

With respect to internal group restructurings, the special rule applies where the common parent of the EAG after the acquisition owns directly or indirectly at least 80 percent of the domestic entity before the acquisition, and non-members of the EAG hold, by reason of holding an interest in the domestic entity, no more than 20 percent of the stock (by vote or value) of the foreign corporation after the acquisition. With respect to transactions between unrelated parties, the special rule applies where, after the acquisition, the former owners of the domestic entity do not own, in the aggregate, directly or indirectly, more than 50 percent of the stock (by vote or value) of any member of the EAG.

Section 1.7874–1T also provides guidance regarding the treatment of certain "subsidiary-owned" interests (which include so-called "hook stock") for purposes of the exceptions to the general application of the ownership fraction. These rules apply to stock or partnership interests owned by an entity in which at least 50 percent

of the stock (by vote or value), or at least 50 percent of the capital or profits interest, is owned directly or indirectly by the issuer of such stock or by the partnership in question.

These rules are included in the final regulations, with revisions as noted below.

B. *Section 1504(a)(4) Preferred Stock*

Both the numerator and denominator of the ownership fraction take into account stock described in section 1504(a)(4) (so-called "plain vanilla preferred stock"). For purposes of determining whether an affiliated group constitutes an EAG, however, such stock is not treated as stock because of the reference to the rules of section 1504(a). See section 7874(c)(1). Commentators have noted the inconsistent treatment of plain vanilla preferred stock in section 7874. In addition, they point out that, due to the debt-like nature of such stock, it should not be treated as stock for any purpose of section 7874, including the ownership fraction.

The Treasury Department and the IRS note that Congress has expressly stated that section 1504(a)(4) preferred stock is not treated as stock in several Code provisions, including certain provisions of section 7874, as noted above. See, for example, sections 243(c)(1), 246A(c)(4), and 355(g)(2)(B)(iv)(III). In contrast, Congress specifically chose not to exclude plain vanilla preferred stock from the ownership fraction. Although section 7874 grants the Treasury Department and the IRS the authority to treat stock as not stock when such treatment would further the purposes of section 7874, the legislative history to section 7874 does not suggest that the treatment of plain vanilla preferred stock in the ownership fraction is inconsistent with the purposes of section 7874. The Treasury Department and the IRS therefore decline to exercise the regulatory authority to exclude plain vanilla preferred stock in the calculation of the ownership fraction. Accordingly, all classes of stock, including plain vanilla preferred stock, are included in the ownership fraction and treated as stock for purposes of section 7874, other than for purposes of determining the EAG.

The Treasury Department and the IRS considered whether the treatment of plain vanilla preferred stock in the EAG definition should be made consistent with the treatment of plain vanilla preferred stock in the ownership fraction. After studying the issue, the Treasury Department and the IRS believe that taking plain vanilla preferred stock into account for purposes of the definition of an EAG may facilitate the avoidance of the rules regarding EAGs. Consequently, the Treasury Department and the IRS also decline to exercise regulatory authority to amend the treatment of plain vanilla preferred stock for purposes of defining an EAG.

The Treasury Department and the IRS will, however, continue to monitor the use of vanilla preferred stock and its treatment under section 7874.

C. *Internal Restructuring Exception*

Treasury regulation §1.7874–1T(c)(1) provides that stock held by a member of an EAG is included in the denominator, but not the numerator, of the ownership fraction if two conditions are satisfied. First, the common parent of the EAG must own directly or indirectly at least 80 percent of the stock (by vote or value) or the capital or profits interest in the domestic entity prior to the acquisition. Second, following the acquisition non-members of the EAG, by reason of holding stock or a capital or profits interest in the domestic entity, must not own more than 20 percent of the stock (by vote or value) of the foreign corporation.

One commentator suggested that the requirement should merely look to the stock ownership of the common parent of the EAG both before and after the acquisition. The Treasury Department and the IRS agree with this suggestion. In addition, the Treasury Department and the IRS have determined that the rule should be modified to consider the stock by vote and value held by the common parent of the EAG. Consequently, stock of a member of an EAG is included in the denominator, but not the numerator of the ownership fraction, if the common parent of the EAG held directly or indirectly at least 80 percent of the stock (by vote and value) or the capital and profits interest, as applicable, of the domestic entity before the acquisition, and holds at least 80 percent of the stock (by vote and value) of the foreign acquiring corporation after the acquisition. Corresponding revisions have been made to the examples.

D. *Hook Stock*

One commentator requested clarification of the wording of §1.7874–1T(d) regarding the treatment of hook stock. In response to this comment, the provision is clarified to exclude hook stock from both the numerator and denominator of the fractions that are used to determine whether the exceptions to the general rule apply (that is, the determination of whether the acquisition resulted in an internal group restructuring or a loss of control of the domestic entity).

Regulations Addressing Avoidance of the Purposes of Section 7874

The Treasury Department and the IRS understand that taxpayers may be taking the position that a foreign corporation that acquires substantially all of the properties of a domestic corporation in a title 11 or similar case may not be a surrogate foreign corporation because it fails to satisfy the stock ownership requirement described in section 7874(a)(2)(B)(ii). These taxpayers maintain that creditors of the domestic corporation, which typically receive all of the stock of the acquiring foreign corporation issued in the title 11 or similar case, are not considered former shareholders of the domestic corporation for purposes of section 7874(a)(2)(B)(ii). Thus, they take the position that the creditors do not hold the stock of the foreign acquiring corporation received by reason of holding stock in the domestic corporation. Under this position, there often would be little or no continuity of ownership for purposes of section 7874(a)(2)(B)(ii) and, as a result, the foreign corporation would not be a surrogate foreign corporation. Taxpayers take this position even though the creditors, in substance, are the equity owners of the domestic corporation at the time of the title 11 or similar case and acquire the stock issued by the acquiring foreign corporation by reason of their status as creditors of the domestic corporation. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).

The Treasury Department and the IRS disagree with this characterization under current law and are considering issuing regulations to clarify the proper application of the rules to such transactions. Section 7874(c)(6) provides that the Secretary

shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations: (i) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and (ii) to treat stock as not stock. These regulations would provide, as appropriate, that for purposes of section 7874(a)(2)(B)(ii), creditors of a domestic corporation emerging from a title 11 or similar case are treated as former shareholders of such corporation. The regulations would further provide, as appropriate, that for this purpose, stock issued by the foreign acquiring corporation to such creditors is held by reason of holding stock in the domestic corporation. Similar rules may apply to acquisitions of substantially all the properties constituting a trade or business of a domestic partnership.

The Treasury Department and the IRS also understand that some taxpayers may be taking the position that, where two or more domestic entities described in section 7874(a)(2)(B)(i) are acquired pursuant to an overall plan, section 7874(a)(2)(B) is applied separately to each such domestic entity. For example, taxpayers may take this position where a foreign corporation is formed to acquire, in exchange for its stock, 100 percent of the stock of two domestic corporations that have approximately the same value. In such a case, after the acquisition the former shareholders of the two domestic corporations, in the aggregate, would hold 100 percent of the stock of the foreign acquiring corporation by reason of holding stock in the domestic corporations. However, the taxpayers may claim that the ownership fraction applies separately to each acquisition such that the ownership fraction would be approximately 50 percent, rather than 100 percent. Under this interpretation, the acquiring foreign corporation would not be a surrogate foreign corporation because the condition described in section 7874(a)(2)(B)(ii) would not be satisfied.

The Treasury Department and the IRS disagree with this interpretation under current law and are considering issuing regulations to clarify the proper application of the rules. These regulations would clarify that the references in section 7874(a)(2)(B) to "a domestic corporation" shall, as appropriate, mean "one or more domestic corporations" where the properties of such corporations are, directly or indirectly, acquired pursuant to the same plan. Similar clarifications will be made with respect to acquisitions involving properties of domestic partnerships.

Finally, the Treasury Department and the IRS understand that some taxpayers may be attempting to avoid the application of section 7874 by structuring acquisitions of domestic entities by foreign corporations through the use of intervening partnerships. For example, a foreign acquiring corporation may issue new shares to a newly formed domestic partnership in exchange for a 99 percent interest in the partnership. The shares transferred to the domestic partnership constitute 70 percent of the outstanding stock of the foreign acquiring corporation. An affiliate of the foreign acquiring corporation would transfer cash or other property to the partnership for the remaining one percent interest. The foreign acquiring corporation then transfers its 99 percent interest in the domestic partnership to the shareholders of a domestic corporation in exchange for 100 percent of the stock of the domestic corporation.

The taxpayers take the position that this transaction is not subject to section 7874 even though, in substance, the foreign acquiring corporation acquired 100 percent of the stock of the domestic corporation and the former shareholders of the domestic corporation, through their 99 percent interest in the domestic partnership, hold more than 60 percent of the stock of the foreign acquiring corporation by reason of holding stock in the domestic corporation. Under this interpretation, which relies on treating the partnership as an entity (rather than as an aggregate of its partners), the ownership fraction would be zero because none of the foreign acquiring corporation stock held by the partnership was held by former shareholders of the domestic corporation. Thus, section 7874 would not apply to the transaction.

The Treasury Department and the IRS disagree with this characterization under current law and are considering issuing regulations to clarify the proper application of the rules to these transactions. The regulations would provide, as appropriate, that for purposes of applying section 7874(a)(2)(B)(i) to these structures, the exchange of an interest in a domestic entity for an interest in a partnership shall be treated as an exchange of the interest in the domestic entity for a *pro rata* share of the assets of the partnership.

The regulations described above, which may be issued in conjunction with the finalization of the §1.7874–2T regulations, may be effective as of May 20, 2008. However, no inference is intended as to the potential applicability of other Code or regulatory provisions, or judicial doctrines (including substance over form) to the transactions described above.

Effective/Applicability date

Section 1.7874–1 applies to acquisitions completed on or after May 20, 2008, subject to transition relief for certain acquisitions entered into pursuant to binding commitments. In addition, taxpayers may elect to apply this section to prior acquisitions, but must apply it consistently to all acquisitions within its scope.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because these regulations do not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small business.

Drafting Information

The principal author of this regulation is Milton Cahn, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.7874–1 also issued under 26 U.S.C. 7874(c)(6) and (g).

§1.7874–1T [Removed]

Par. 2. Section 1.7874–1T is removed.

Par. 3. Section 1.7874–1 is added to read as follows:

§1.7874–1 Disregard of affiliate-owned stock.

(a) *Scope*. Section 7874(c)(2)(A) provides that stock of the foreign corporation referred to in section 7874(a)(2)(B) held by members of the expanded affiliated group (EAG) that includes such foreign corporation shall not be taken into account in determining ownership for purposes of section 7874(a)(2)(B)(ii). This section provides rules under section 7874(c)(2)(A). The rules provided in this section are also subject to section 7874(c)(4).

(b) *General rule*. Except as provided in paragraph (c) of this section, for purposes of the ownership percentage determination required by section 7874(a)(2)(B)(ii), stock held by one or more members of the EAG is not included in either the numerator or the denominator of the fraction that determines such percentage (ownership fraction).

(c) *Exceptions to general rule*—(1) *Overview*. Stock held by one or more members of the EAG shall be included in the denominator, but not in the numerator, of the ownership fraction, if the acquisition qualifies as an *internal group restructuring* or results in a *loss of control*, as described in paragraph (c)(2) and (c)(3) of this section.

(2) *Internal group restructuring*. For purposes of paragraph (c)(1) of this section, an acquisition qualifies as an internal group restructuring if:

(i) Before the acquisition, 80 percent or more of the stock (by vote and value) or the capital and profits interest, as applicable, of the domestic entity was held directly or indirectly by the corporation that is the common parent of the EAG after the acquisition; and

(ii) After the acquisition, 80 percent or more of the stock (by vote and value) of the acquiring foreign corporation is held directly or indirectly by such common parent.

(3) *Loss of control*. For purposes of paragraph (c)(1) of this section, the acquisition results in a loss of control if after the acquisition, the former shareholders or partners of the domestic entity do not hold, in the aggregate, directly or indirectly, more than 50 percent of the stock (by vote or value) of any member of the EAG.

(d) *Treatment of certain hook stock*. This paragraph applies to stock of a corporation that is held by an entity in which at least 50 percent of the stock (by vote or value) or at least 50 percent of the capital or profits interest, as applicable, in such entity, is held directly or indirectly by the corporation. The stock to which this paragraph applies shall not be included in either the numerator or denominator of any fraction for the following purposes:

(1) For applying paragraph (c)(1) of this section; and

(2) For determining whether the acquisition qualifies as an internal group restructuring (described in paragraph (c)(2) of this section) or results in a loss of control (described in paragraph (c)(3) of this section).

(e) *Stock held by a partnership*. For purposes of section 7874, stock held by a partnership shall be considered as held proportionately by its partners.

(f) *Examples*. The application of this section is illustrated by the following examples. It is assumed that all transactions in the examples occur after March 4, 2003. In all the examples, if an entity or other person is not described as either domestic or foreign, it may be either domestic or foreign. In addition, each entity has only a single class of equity outstanding. Finally, the analysis of the following examples is limited to a discussion of issues under section 7874, even though the examples may raise other issues (for example, under section 367).

Example 1. Disregard of hook stock—(i) *Facts*. USS, a domestic corporation, has 100 shares of stock outstanding. USS's stock is held by a group of individuals. Pursuant to a plan, USS forms FS, a foreign corporation, and transfers to FS the stock of several wholly owned foreign corporations, in exchange for 90 shares of FS stock. FS then forms Merger Sub, a domestic corporation. Under a merger agreement and state law, Merger Sub merges into USS, with USS surviving the merger. In exchange for their USS stock, the former shareholders of USS receive, in the aggregate, 100 shares of newly issued FS stock. As a result of the merger FS holds 100 percent of the USS stock. USS continues to hold 90 shares of FS stock.

(ii) *Analysis*. FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. After the acquisition, the former shareholders of USS hold 100 shares of FS stock by reason of holding stock in USS, and USS holds 90 shares of FS stock. Under paragraph (b) of this section, the 90 shares of FS stock held by USS, a member of the EAG, are not included in either the numerator or the denominator of the ownership fraction. Accordingly, the ownership fraction is 100/100. If the condition in section 7874(a)(2)(B)(iii) is satisfied, FS is a surrogate foreign corporation which is treated as a domestic corporation under section 7874(b).

Example 2. Internal group restructuring; wholly owned corporation—(i) *Facts*. P, a corporation, owns all 100 outstanding shares of USS, a domestic corporation. USS forms FS, a foreign corporation, and transfers all its assets to FS in exchange for all 100 shares of the stock of FS, in a reorganization described in section 368(a)(1). P exchanges its USS stock for FS stock under section 354.

(ii) *Analysis*. FS has directly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. The acquisition is an internal group restructuring described in paragraph (c)(2) of this section because P, the common parent of the EAG after the acquisition, held directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition, P holds directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Accordingly, under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not in the numerator of the ownership fraction. Therefore, the ownership fraction is 0/100. FS is not a surrogate foreign corporation.

Example 3. Internal group restructuring; wholly owned corporation—(i) *Facts*. The facts are the same as in *Example 2*, except that USS does not transfer any of its assets to FS. Instead, P transfers all 100 shares of USS stock to FS in exchange for all 100 shares of FS stock.

(ii) *Analysis*. FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. The acquisition is an internal group restructuring described in paragraph (c)(2) of this section because P, the common parent of the EAG after the acquisition, held directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition, P holds directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Accordingly, under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not in the numerator of the ownership fraction. Accordingly, the ownership fraction is 0/100. FS is not a surrogate foreign corporation.

Example 4. Internal group restructuring; less than wholly owned corporation—(i) *Facts*. The facts are the same as in *Example 3*, except that P holds 85 shares of USS stock. The remaining 15 shares of USS stock are held by A, a person unrelated to P. P and A

transfer their shares of USS stock to FS in exchange for 85 and 15 shares of FS stock, respectively.

(ii) *Analysis*. FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. The acquisition is an internal group restructuring described in paragraph (c)(2) of this section because P, the common parent of the EAG after the acquisition, held directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition P holds directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Therefore, under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not in the numerator of the ownership fraction. Accordingly, the ownership fraction is 15/100. FS is not a surrogate foreign corporation.

Example 5. Internal group restructuring exception not applicable; less than 80 percent owned corporation—(i) *Facts*. The facts are the same as in *Example 2*, except that P owns 55 shares of USS stock, and A, a person unrelated to P, holds 45 shares of USS stock. P and A exchange their shares of USS stock for 55 shares and 45 shares of FS stock, respectively.

(ii) *Analysis*. FS has acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. P, the common parent of the EAG after the acquisition, did not hold directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition P does not hold directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Thus, the acquisition is not an internal group restructuring described in paragraph (c)(1) of this section, and the general rule of paragraph (b) of this section applies. Under paragraph (b) of this section, the FS stock held by P, a member of the EAG, is not included in either the numerator or the denominator of the ownership fraction. Accordingly, the ownership fraction is 45/45. If the condition in section 7874(a)(2)(B)(iii) is satisfied, FS is a surrogate foreign corporation which is treated as a domestic corporation under section 7874(b).

Example 6. Internal group restructuring; hook stock—(i) *Facts*. USS, a domestic corporation, has 100 shares of stock outstanding. P, a corporation, holds 80 shares of USS stock. The remaining 20 shares of USS stock are held by A, a person unrelated to P. USS owns all 30 outstanding shares of FS, a foreign corporation. Pursuant to a plan, FS forms Merger Sub, a domestic corporation. Under a merger agreement and state law, Merger Sub merges into USS, with USS surviving the merger as a subsidiary of FS. In exchange for their USS stock, P and A, the former shareholders of USS, respectively receive 56 and 14 shares of FS stock. USS continues to hold 30 shares of FS stock.

(ii) *Analysis*. FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. Under paragraph (b) of this section, the shares of FS stock held by P and USS, both of which are members of the EAG, are not included in either the numerator or denominator of the ownership fraction, unless the acquisition results in an internal group restructuring or loss of control of USS such that the exception of paragraph (c)(1) of this section applies. In determining whether the acquisition of USS is an internal group restructuring, under paragraph (d)(2) of this section, the FS stock held by USS is disregarded. Because P held directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition P holds directly or indirectly 80 percent or more of the stock (by vote and value) of FS (when disregarding the FS stock held by USS), the acquisition is an internal group restructuring and the exception of paragraph (c)(1) of this section applies. Accordingly, when determining whether FS is a surrogate foreign corporation, the FS stock held by P is included in the denominator, but not the numerator of the ownership fraction. However, under paragraph (b) of this section, the FS stock held by USS is not included in either the numerator or denominator of the ownership fraction. Accordingly, the ownership fraction is 14/70, or 20 percent, since only the stock held by A is included in the numerator, and the stock held by both P and A is included in the denominator. Accordingly, FS is not a surrogate foreign corporation.

Example 7. Loss of control—(i) *Facts*. P, a corporation, holds all the outstanding stock of USS, a domestic corporation. B, a corporation unrelated to P, holds all 60 outstanding shares of FS, a foreign corporation. P transfers to FS all the outstanding stock of USS in exchange for 40 newly issued shares of FS.

(ii) *Analysis*. FS has indirectly acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. After the acquisition, B holds 60 percent of the outstanding shares of the FS stock. Accordingly, B, FS and USS are members of an EAG. After the acquisition, P does not hold directly or indirectly more than 50 percent of the stock (by vote or value) of any member of the EAG and, thus, the acquisition results in a loss of control described in paragraph (c)(3) of this section. Accordingly, under paragraph (c)(1) of this section, the FS stock owned by B is included in the denominator, but not in the numerator, of the ownership fraction. Therefore, the ownership fraction is 40/100. FS is not a surrogate foreign corporation.

Example 8. Internal group restructuring; partnership—(i) *Facts*. LLC, a Delaware limited liability company, is engaged in the conduct of a trade or business. P, a corporation, holds 90 percent of the interests of LLC. A, a person unrelated to P, holds 10 percent of the interests of LLC. LLC has not elected to be treated as an association taxable as a corporation. P and A transfer their interests in LLC to FS, a newly formed foreign corporation, in exchange for 90 shares and 10 shares, respectively, of FS's stock, which are all of the outstanding shares of FS. Accordingly, LLC becomes a disregarded entity.

(ii) *Analysis*. Prior to the FS's acquisition of the interests of LLC, LLC was a domestic partnership for Federal income tax purposes. FS has acquired substantially all the properties constituting a trade or business of LLC pursuant to a plan. After the acquisition, P holds 90 percent of FS's stock (by vote and value) by reason of holding a capital and profits interest in LLC, and A holds 10 percent of FS's stock (by vote and value) by reason of holding a capital and profits interest in LLC. The internal group restructuring exception under paragraph (c)(2) of this section applies, because before the acquisition, P held 80 percent or more of the capital and profits interest in LLC, and after the acquisition, P holds 80 percent or more of the stock (by vote and value) of FS. Under paragraph (c)(1) of this section, the FS stock held by P is included in the denominator, but not the numerator, of the ownership fraction. Accordingly, the ownership fraction is 10/100. FS is not a surrogate foreign corporation.

(g) *Effective/applicability date*. Except as otherwise provided in this paragraph, this section shall apply to acquisitions completed on or after May 20, 2008. This section shall not, however, apply to an acquisition that was completed on or after May 20, 2008, provided such acquisition was entered into pursuant to a written agreement which was (subject to customary conditions) binding prior to May 20, 2008, and at all times thereafter (binding commitment). For purposes of the preceding sentence, a binding commitment shall include entering into options and similar interests in connection with one or more written agreements described in the preceding sentence. Notwithstanding the general application of this paragraph, taxpayers may elect to apply this section to prior acquisitions, but must apply it consistently to all acquisitions within its scope.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

Approved May 8, 2008.

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

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Part III. Administrative, Procedural, and Miscellaneous

Health Savings Accounts

Notice 2008–51

Section 307 of the Health Opportunity Patient Empowerment Act of 2006 (the Act) added § 408(d)(9) to the Internal Revenue Code. The Act is part of the Tax Relief and Health Care Act of 2006, enacted December 20, 2006, Pub. L. No. 109–432. This notice provides guidance on a qualified HSA funding distribution from an individual's Individual Retirement Account (IRA) or Roth IRA to a Health Savings Account (HSA). The qualified HSA funding distribution is a one-time transfer from an individual's IRA to his or her HSA and generally excluded from gross income and is not subject to the 10 percent additional tax under § 72(t).

BACKGROUND

Eligible individuals

Generally, only eligible individuals (as defined in § 223(c)(1)) may contribute to HSAs. Maximum annual HSA contributions are based on an individual's eligibility, age, and health plan coverage.

General rules on taxation of distributions from IRAs

A distribution from an IRA under § 408 generally is included in gross income. If an IRA owner made nondeductible contributions to the IRA, those contributions are recovered on a *pro-rata* basis and the distribution is partly included in and partly excluded from gross income under the rules of § 408(d) and § 72(e)(8).

A nonqualified distribution from a Roth IRA under § 408A is included in gross income only to the extent that earnings are distributed. A qualified Roth IRA distribution (as defined in § 408A(d)) is excluded from gross income.

If a distribution from an IRA or Roth IRA is made before the IRA or Roth IRA account owner attains age 59½, the distribution also is subject to a 10 percent additional tax under § 72(t) unless an exception applies. These exceptions include distributions made on account of death or disability, and distributions made as part of a series of substantially equal periodic payments for the life expectancy of the IRA holder.

HEALTH OPPORTUNITY PATIENT EMPOWERMENT ACT OF 2006

Tax treatment of qualified HSA funding distributions

Section 408(d)(9) provides, in general, that a qualified HSA funding distribution from an individual's IRA or Roth IRA to that individual's HSA is not included in gross income, if the individual is an eligible individual under § 223(c)(1). Moreover, notwithstanding the *pro-rata* basis recovery rules under § 72, for purposes of determining the basis in any amount remaining in an IRA or Roth IRA following a qualified HSA funding distribution, the qualified HSA funding distribution is treated as included in gross income to the extent that such amount does not exceed the aggregate amount which would have been so included if there were a total distribution from the IRA or Roth IRA owner's accounts. For example, suppose an individual who has $200 of basis in an IRA with a fair market value of $2,000 makes a qualified HSA funding distribution of $1,500 from the IRA. Immediately after the qualified HSA funding distribution, the individual retains $200 of basis in an IRA that has a fair market value of $500.

If a qualified HSA funding distribution from an individual's IRA or Roth IRA exceeds the aggregate amount which would have been included in gross income if there were a total distribution from that individual's IRA or Roth IRA accounts, the individual's basis in the excess amount (*i.e.*, the amount that would have been excluded from gross income in a distribution to which § 408(d)(9) did not apply) does not carry over to the HSA.

A qualified HSA funding distribution is not subject to the 10 percent additional tax under § 72(t). However, if the qualified HSA funding distribution results in a modification of a series of substantially equal periodic payments that, prior to the modification, qualify for the exception to the 10 percent additional tax under § 72(t)(2)(A)(iv), and such modification results in the imposition of the recapture tax under the rules of § 72(t)(4), the recapture tax applies to the payments made before the date of the qualified HSA funding distribution.

The amount contributed to the HSA through a qualified HSA funding distribution is not allowed as a deduction and counts against the individual's maximum annual HSA contribution for the taxable year of the distribution. In addition, the taxability of these distributions is subject to the testing period rules in § 408(d)(9)(D), discussed below.

Qualified HSA funding distribution only from certain types of IRAs

A qualified HSA funding distribution may be made from a traditional IRA under § 408 or a Roth IRA under § 408A, but not from an ongoing SIMPLE IRA under § 408(p) or an ongoing SEP IRA under § 408(k). For this purpose, a SIMPLE IRA or SEP IRA is treated as ongoing if an employer contribution is made for the plan year ending with or within the IRA owner's taxable year in which the qualified HSA funding distribution would be made.

After the death of an IRA or Roth IRA account owner, a qualified HSA funding distribution may be made from an IRA or Roth IRA maintained for the benefit of an IRA or Roth IRA beneficiary. This distribution will 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.

Maximum amount of qualified HSA funding distribution

For purposes of § 408(d)(9)(C)(i), a qualified HSA funding distribution from the IRA or Roth IRA of an eligible individual to that individual's HSA must be less than or equal to the IRA or Roth IRA account owner's maximum annual HSA contribution. The maximum annual HSA contribution is based on (1) the individual's age as of the end of the taxable year and (2) the individual's type of high deductible health plan (HDHP) coverage (self-only or family HDHP coverage) at the time of the distribution. For example, in 2008, an IRA owner who is an eligible individual with

family HDHP coverage at the time of the distribution and who is age 55 or over by the end of the year is allowed a qualified HSA funding distribution of $5,800, plus the $900 catch-up contribution. An IRA or Roth IRA owner who is an eligible individual with self-only HDHP coverage, and who is under age 55 as of the end of the taxable year, is allowed a qualified HSA funding distribution of $2,900 for 2008.

One-time qualified HSA funding distribution

Generally, only one qualified HSA funding distribution is allowed during the lifetime of an individual. If, however, the distribution occurs when the individual has self-only HDHP coverage, and later in the same taxable year the individual has family HDHP coverage, the individual is allowed a second qualified HSA funding distribution in that taxable year. Both distributions count against the individual's maximum HSA contribution for that taxable year. The distributions must be from an IRA or Roth IRA to an HSA owned by the individual who owns the IRA or Roth IRA or, in the case of an inherited IRA, for whom the IRA or Roth IRA is maintained (*i.e.*, a qualified HSA funding distribution cannot be made to an HSA owned by any other person, including the individual's spouse). IRA or Roth IRA owners are not required to make the maximum qualified HSA funding distribution or to make any qualified HSA funding distribution.

If an individual owns two or more IRAs, and wants to use amounts in multiple IRAs to make a qualified HSA funding distribution, the individual must first make an IRA-to-IRA transfer of the amounts to be distributed into a single IRA, and then make the one-time qualified HSA funding distribution from that IRA.

No deemed distribution date

A qualified HSA funding distribution relates to the taxable year in which the distribution is actually made. The rules in § 223(d)(4)(B) and § 219(f)(3) (contributions made before the deadline for filing the individual's federal income tax return are deemed to be made on the last day of the preceding taxable year) do not apply to qualified HSA funding distributions.

Procedures for making the transfer from an IRA to an HSA

An individual must be an eligible individual (as defined in § 223(c)(1)) at the time of the qualified HSA funding distribution. The distribution must be a direct transfer from an IRA or Roth IRA to an HSA. For example, if a check from an IRA or Roth IRA is made payable to an HSA trustee or custodian and delivered by the IRA or Roth IRA account owner to the HSA trustee or custodian, the payment to the HSA will be considered a direct payment by the IRA or Roth IRA trustee, custodian or issuer to the HSA for purposes of § 408(d)(9).

Testing period rules

If a qualified HSA funding distribution is made from the individual's IRA or Roth IRA to the individual's HSA under § 408(d)(9) and the individual remains an eligible individual during the entire testing period, the amount of the qualified HSA funding distribution is excluded from the individual's gross income and the 10 percent additional tax under § 408(d)(9)(D) does not apply. The testing period begins with the month in which the qualified HSA funding distribution is contributed to the HSA and ends on the last day of the 12th month following that month. Each qualified HSA funding distribution allowed in § 408(d)(9)(C)(ii)(II) has a separate testing period. For testing period purposes, an eligible individual who changes from family HDHP coverage to self-only HDHP coverage during the testing period remains an eligible individual. If at any time during the testing period the individual ceases to meet all requirements to be an eligible individual, the amount of the qualified HSA funding distribution is included in the individual's gross income. The qualified HSA funding distribution is included in gross income in the taxable year of the individual in which the individual first fails to be an eligible individual. This amount is subject to the 10 percent additional tax (unless the failure is due to disability, as defined in § 72(m)(7), or death). See § 408(d)(9)(D). Earnings on the amount of the qualified HSA funding distribution are not included in gross income. Amounts included in the IRA or Roth IRA owner's gross income under § 408(d)(9)(D) are not also included in gross income under §§ 408(d)(1) or (2), nor do the § 72 rules apply (including the additional tax under § 72(t)).

No interaction between testing periods

Section 223(b)(8)(B) provides generally that if an individual fails to remain an eligible individual during the § 223(b)(8) testing period, an amount is included in the individual's gross income (computed by subtracting the sum of the monthly contribution limits that the individual would otherwise have been entitled to under §§ 223(b)(1) and (2) from the amount actually contributed). The testing period rules in § 223(b)(8)(B) do not apply to amounts contributed to an HSA through a qualified HSA funding distribution. Thus, if an individual remains an eligible individual during the entire § 408(d)(9) testing period, then no amount of the qualified HSA funding distribution is included in income and the 10 percent additional tax under § 223(b)(8)(B) does not apply.

Application of § 223(b)(8)(B) testing period to contributions which are not qualified HSA funding distributions

If an HSA account beneficiary's contributions to his or her HSA in a taxable year include both a qualified HSA funding distribution (or distributions) and other contributions subject to § 223(b)(8), the § 408(d)(9)(D) testing period rules apply to the qualified HSA funding distribution (or distributions) and the § 223(b)(8)(B) testing period rules apply to the other contributions. If the individual fails to remain an eligible individual during the § 223(b)(8)(B) testing period, but does remain a qualified individual during the § 408(d)(9)(D) testing period, the amount included in the individual's gross income is the lesser of:

(1) the amount that would otherwise be included under the § 223(b)(8)(B) rules; or

(2) the amount of contributions to the HSA for the taxable year other than the amount contributed through qualified HSA funding distributions.

HSA distributions not used for qualified medical expenses

An HSA distribution not used for qualified medical expenses (as defined in § 223(d)(2)) is included in gross income

under § 223(f)(2) and subject to the 10 percent additional tax under § 223(f)(4) (with certain exceptions), regardless of whether the amount contributed to the HSA under the qualified HSA funding distribution is included in the account beneficiary's income and subject to the additional tax under § 408(d)(9)(D). See Notice 2007–22, 2007–10 I.R.B. 670, regarding the consequences of distributions from HSAs.

EXAMPLES

The following examples illustrate these rules. It is assumed in the examples that no previous qualified HSA funding distributions have been made by the individual, and that all distributions are from IRAs and are otherwise included in the IRA owner's gross income. None of the IRAs are ongoing SEP IRAs described in § 408(k), or ongoing SIMPLE IRAs described in § 408(p). For purposes of § 223(f)(4) and § 408(d)(9)(D)(ii), none of the IRA owners or HSA account beneficiaries are disabled. None of the exceptions to the 10 percent tax under § 72(t) apply.

Example 1. Individual A, age 45, enrolls in family HDHP coverage on January 1, 2008, is otherwise an eligible individual (as defined in § 223(c)(1)) as of that date and through December 31, 2009. A's maximum annual HSA contribution for 2008 is $5,800. A owns an IRA with a balance of $2,000. A direct trustee-to-trustee transfer of $2,000 is made from A's IRA trustee to A's HSA trustee on April 2, 2008.

The $2,000 distribution is a qualified HSA funding distribution, and accordingly is not included in A's gross income and is not subject to the additional tax under § 72(t). A's testing period with respect to the qualified HSA funding distribution begins in April 2008 and ends on April 30, 2009. After the qualified HSA funding distribution of $2,000, $3,800 of A's 2008 HSA maximum annual contribution remains.

Example 2. Same facts as *Example 1*, except that A ceases to be an eligible individual on January 1, 2009. Under § 408(d)(9)(D), in 2009 A must include $2,000 in gross income, the amount of the qualified HSA funding distribution, plus an additional tax of $200 (10 percent of the amount included in income).

Example 3. Individual B, age 57, enrolls in self-only HDHP coverage effective January 1, 2008, is otherwise an eligible individual as of that date and through December 31, 2009. B's maximum annual HSA contribution for 2008 is $3,800 ($2,900 plus the $900 catch-up contribution). B owns an IRA with a balance of $13,550. A direct trustee-to-trustee transfer of $3,800 is made from B's IRA trustee to B's HSA trustee on June 4, 2008.

The $3,800 distribution is a qualified HSA funding distribution. The distribution from B's IRA is not included in B's gross income and is not subject to the additional tax under § 72(t). The qualified HSA funding distribution of $3,800 equals B's 2008 maximum annual HSA contribution. B's testing period with respect to the qualified HSA funding distribution begins in June 2008 and ends on June 30, 2009.

Example 4. Individual C, age 38, enrolls in self-only HDHP coverage on January 1, 2008, is otherwise an eligible individual on January 1, and remains an eligible individual through December 31, 2009. C owns an IRA with a balance of $12,550. A qualified HSA funding distribution of $2,800 is made from C's IRA trustee directly to C's HSA trustee on June 4, 2008.

On August 1, C enrolls in family HDHP coverage. A transfer of $3,000 is made from C's IRA trustee directly to C's HSA trustee on August 15, 2008.

The $2,800 and $3,000 distributions are qualified HSA funding distributions. The distributions from the IRA are not included in C's gross income and are not subject to the additional tax under § 72(t). The qualified HSA funding distributions of $5,800 ($2,800 + $3,000) equal C's 2008 maximum annual HSA contribution. C's testing period for the first qualified HSA funding distribution begins in June 2008 and ends on June 30, 2009 and the testing period for the second qualified HSA funding distribution begins in August 2008 and ends on August 31, 2009.

Example 5. Individual D, age 43, enrolls in family HDHP coverage on January 1, 2008, is otherwise an eligible individual on January 1, and remains an eligible individual through December 31, 2009. D owns an IRA with a balance of $17,500. A qualified HSA funding distribution of $5,800 is made from D's IRA trustee directly to D's HSA trustee on March 18, 2008.

On June 1, D changes from family HDHP coverage to self-only HDHP coverage. The $5,800 distribution from the IRA is not included in D's gross income and is not subject to the additional tax under § 72(t). The qualified HSA funding distribution of $5,800 equals D's maximum annual HSA contribution at the time the transfer occurred. D's testing period begins in March 2008 and ends on March 31, 2009.

Example 6. Individual E, age 50, begins family HDHP coverage and is first an eligible individual on June 1, 2008. E owns an IRA with a balance of $20,000. A direct trustee-to-trustee transfer of $3,500 is made from E's IRA trustee to E's HSA trustee on June 4, 2008. On June 4, 2008 E also contributes $2,300 in cash to his HSA for a total contribution of $5,800. On July 1, 2009, E ceases to be an eligible individual.

The $3,500 distribution is a qualified HSA funding distribution, is not included in E's gross income, and is not subject to the additional tax under § 72(t). E's testing period with respect to the qualified HSA funding distribution begins in June 2008 and ends on June 30, 2009. E remains an eligible individual during the qualified HSA funding distribution testing period. No amount of the $3,500 distribution is included in E's gross income.

The testing period for the $2,300 contribution begins in December 2008 and ends on December 31, 2009. E's full contribution limit under § 223(b)(8) for 2008 is $5,800. E's sum of the monthly contribution limits is $3,383 (7/12 x $5,800). E's maximum annual contribution for 2008 is $5,800, the greater of $5,800 or $3,383.

The amount included in E's gross income and subject to the 10 percent additional tax under § 223(b)(8)(B) in 2009 is $2,417 ($5,800 - $3,383). The cash contribution to E's HSA is $2,300. The amount included in E's gross income and subject to additional tax is $2,300, the lesser of $2,417 or $2,300.

Example 7. Same facts as *Example 6*, except that the distribution from E's IRA to E's HSA is $1,000 and E contributes $4,800 in cash for a total HSA contribution of $5,800 in 2008.

E remains an eligible individual during the qualified HSA funding distribution testing period. No amount of the $1,000 distribution is included in E's gross income.

E's full contribution limit under § 223(b)(8) for 2008 is $5,800. E's sum of the monthly contribution limits is $3,383 (7/12 x $5,800). E's maximum annual contribution limit for 2008 is $5,800, the greater of $5,800 or $3,383. The amount included in E's gross income and subject to the 10 percent additional tax under § 223(b)(8)(B) is $2,417 ($5,800 - $3,383). The cash contribution to E's HSA is $4,800. The amount included in E's gross income and subject to the additional tax in 2009 is $2,417, the lesser of $2,417 or $4,800.

Example 8. Same facts as *Example 6*, except that E ceases to be an eligible individual on May 1, 2009.

The $3,500 distribution is a qualified HSA funding distribution, is not included in E's gross income in the year of the distribution, and is not subject to the additional tax under § 72(t). E's testing period with respect to the qualified HSA funding distribution begins in June 2008 and ends on June 30, 2009. E ceases to be an eligible individual during the qualified HSA funding distribution testing period. The $3,500 distribution is included in E's gross income. In addition, the 10 percent additional tax ($350) under § 408(d)(9)(D)(II) applies to the amount.

The testing period for the $2,300 contribution begins in December 2008 and ends on December 31, 2009. E's full contribution limit under § 223(b)(8) for 2008 is $5,800. E's sum of the monthly contribution limits is $3,383 (7/12 x $5,800). E's maximum annual contribution limit for 2008 is $5,800, the greater of $5,800 or $3,383.

The amount included in E's gross income and subject to the 10 percent additional tax in 2009 under § 223(b)(8) is $2,417 ($5,800 - $3,383). The cash contribution to E's HSA is $2,300. The amount included in E's gross income and subject to additional tax is $2,300, the lesser of $2,417 or $2,300.

Example 9. Individual F, age 47, has family HDHP coverage and is first an eligible individual on January 1, 2008. F's maximum annual HSA contribution for 2008 is $5,800. F owns an IRA with a balance of $10,000. A direct trustee-to-trustee transfer of $10,000 is made from F's IRA trustee to F's HSA trustee on September 26, 2008.

The $10,000 contribution exceeds F's $5,800 contribution limit. In 2008, $4,200 ($10,000 - $5,800) is included in F's gross income under § 408 as a taxable IRA distribution. The $4,200 is also subject to additional tax under § 72(t), as well as an excise tax on excess HSA contributions under § 4973.

Example 10. Individual G, age 32, has self-only HDHP coverage and is first an eligible individual on January 1, 2007. G remains an eligible individual

through December 31, 2009. G's maximum annual HSA contribution for 2007 is $2,850 and $2,900 for 2008. G owns an IRA with a balance of $4,500. A direct trustee-to-trustee transfer of $1,000 from G's IRA trustee to G's HSA trustee is made on September 6, 2007.

Another direct trustee-to-trustee transfer of $1,500 from G's IRA trustee to G's HSA trustee is made on April 28, 2008. G makes no other contributions to his HSA for 2008.

The $1,000 contribution to G's HSA in September 2007 is a qualified HSA funding distribution, is not included in G's gross income, and is not subject to the additional tax under § 72(t). G's testing period with respect to this contribution begins in September 2007 and ends on September 30, 2008.

The $1,500 contribution to G's HSA in April 2008 is not a qualified HSA funding distribution, is included in G's gross income for 2008 under § 408 as a taxable IRA distribution, and is subject to the additional tax under § 72(t). However, the $1,500 contribution to G's HSA is allowed as a deduction under § 223(a) in 2008, because G remains an eligible individual in 2008 and has not otherwise made contributions to the HSA or had contributions on G's behalf made to an HSA in excess of $1,400 for 2008. No testing period under § 408 applies to the $1,500 contribution.

REPORTING AND WITHHOLDING

Employers are not responsible for reporting whether an employee remains an eligible individual during the testing period.

A qualified HSA funding distribution is not subject to withholding under § 3405 because an IRA or Roth 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 or Roth IRA owner satisfies the requirements of § 408(d)(9), the IRA or Roth IRA trustee may rely upon reasonable representations made by the account owner.

EFFECTIVE DATE

Sections 408(d)(9) and 223(b)(4)(C), allowing qualified HSA funding distributions from IRAs to HSAs, are effective for taxable years beginning after December 31, 2006.

DRAFTING INFORMATION

The principal author of this notice is Leslie R. Paul of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Paul at (202) 622–6080 (not a toll-free call). For information regarding the rules applicable to IRAs, contact Cathy V. Pastor at (202) 622–6090 (not a toll-free call).

Health Savings Accounts

Notice 2008–52

This notice provides guidance on contributions to Health Savings Accounts (HSAs) under amendments to the Internal Revenue Code by §§ 303 and 305 of the Health Opportunity Patient Empowerment Act of 2006 (the Act) included in the Tax Relief and Health Care Act of 2006, enacted December 20, 2006, Pub. L. No. 109–432.

ANNUAL HSA CONTRIBUTION LIMIT

HDHP deductible limit on annual HSA contributions repealed

For 2004 through 2006, the maximum annual HSA contribution was the lesser of (1) the annual deductible under the high deductible health plan (HDHP) or (2) the statutory maximum under § 223(b)(2)(B). See Notice 2004–2, 2004–1 C.B. 269, Q&A–12. Section 303 of the Act repeals the limit on annual HSA contributions based on the amount of the deductible under the HDHP. For 2007 and later years, the indexed maximum HSA contribution under § 223(b)(2)(A) (for self-only HDHP coverage) and § 223(b)(2)(B) (for family HDHP coverage) determines the contribution limit, without regard to an individual's HDHP deductible. Thus, for 2008, the maximum annual HSA contribution is $2,900 for individuals who have self-only HDHP coverage and $5,800 for individuals who have family HDHP coverage.

Annual HSA contribution limits for 2007 and later years

Section 305 of the Act adds § 223(b)(8), which provides that if an individual is an eligible individual on the first day of the last month of the individual's taxable year (December 1 for calendar year taxpayers), the individual's maximum HSA contribution for the year is the greater of the following:

(1) The sum of the limits determined separately for each month under § 223(b)(2), based on eligibility and HDHP coverage on the first day of each month, plus catch-up contributions for each month, if applicable (see sum of the monthly contribution limits discussion below), or

(2) The maximum annual HSA contribution under § 223(b)(2)(A) or § 223(b)(2)(B) based on the individual's HDHP coverage (self-only or family) on the first day of the last month of the individual's taxable year, plus catch-up contributions under § 223(b)(3), if applicable (see full contribution rule under § 223(b)(8) discussion below).

A testing period applies to the full contribution rule (see discussion of the testing period below). If an individual is not an eligible individual on the first day of the last month of the individual's taxable year (December 1 for calendar year taxpayers), the individual's maximum HSA contribution for the year is determined under the sum of the monthly contribution limits rule under § 223(b)(2). See Example 6 below.

Sum of the monthly contribution limits

Eligible individuals (as defined in § 223(c)(1)) may contribute to HSAs. See Notice 2004–2, Q&A–2; Notice 2004–50, 2004–2 C.B. 196, Q&A–2, 3. Under §§ 223(b)(1) and (2), the maximum annual contribution to an HSA is the sum of the monthly contribution limits determined separately for each month, based on eligibility and health plan coverage on the first day of the month. For this purpose, the monthly limit is 1/12 of the indexed amount provided under § 223(b)(2)(A) for self-only coverage ($2,900 for 2008) and under § 223(b)(2)(B) for family coverage ($5,800 for 2008). In addition, the maximum HSA contribution is increased by an additional contribution amount (catch-up amount) for individuals age 55 or older as of the last day of the calendar year who are not enrolled in Medicare. The catch-up contribution is also computed on a monthly basis. Section 223(b)(2).

Full contribution rule

New § 223(b)(8)(A) treats an individual who is an eligible individual on the first day of the last month of the taxable year as

having been an eligible individual for the entire year and may increase, but not decrease, the contribution limit for such an individual. Thus, in order to make a full contribution for the year under § 223(b)(8), a taxpayer must be an eligible individual on the first day of the last month of his or her taxable year (December 1 for calendar year taxpayers). The eligible individual is also treated as enrolled in the same HDHP coverage (*i.e.*, self-only or family coverage) as he or she has on the first day of the last month of the year. For example, if an individual first becomes HSA-eligible on December 1, 2008, and has family HDHP coverage, he or she is treated as an eligible individual and having family HDHP coverage for all twelve months in 2008. This full contribution rule also applies to catch-up contributions. The full contribution rule applies without regard to whether the individual was an eligible individual for the entire year, had HDHP coverage for the entire year, or had disqualifying non-HDHP coverage for part of the year. However, a testing period applies for purposes of the full contribution rule.

The testing period

The testing period applies to an individual who is an eligible individual on the first day of the last month of the taxable year. The testing period begins on the first day of the last month of the taxable year and ends on the last day of the 12th month following that month. Thus, for a calendar year taxpayer, the testing period is from December 1 of the current year to December 31 of the following year. Section 223(b)(8)(B)(iii). For 2008 HSA contributions, the testing period for calendar year taxpayers begins on December 1, 2008 and ends on December 31, 2009.

Failure to remain an eligible individual during the testing period

If an individual who is an eligible individual on the first day of the last month of the taxable year contributes an amount to his or her HSA greater than the sum of the monthly contribution limits under §§ 223(b)(1) and (2), and at any time during the testing period the individual ceases to meet all requirements to be an eligible individual, an amount is included in the individual's gross income and subject to an additional 10 percent tax, unless the failure is due to disability (as defined in § 72(m)(7)) or death.

The amount that is included in the individual's gross income is computed by subtracting the sum of the monthly contribution limits that the individual would otherwise have been entitled to under §§ 223(b)(1) and (2) from the amount actually contributed. Section 223(b)(8)(B). It is not necessary to distribute this amount from the HSA, and there may be additional adverse tax consequences from such a distribution. See discussion below on distributions not used for qualified medical expenses. Withdrawing this amount from the HSA will not prevent the inclusion of the amount in income or the additional 10 percent tax. However, earnings on the amount are not included in gross income or subject to the 10 percent additional tax, so long as the earnings remain in the HSA or are used for qualified medical expenses.

Unlike the additional 10 percent tax under § 223(f)(4)(A), the additional 10 percent tax under § 223(b)(8)(B)(i)(II) applies regardless of the age of the account beneficiary (*i.e.*, even after age 65).

To remain an eligible individual during the testing period, an individual is not required to keep the same level of HDHP coverage during the testing period. Thus, changing from family HDHP coverage to single HDHP coverage during the testing period does not result in inclusion of amounts in gross income or an additional 10 percent tax. See Examples 8 and 14 below.

Excise tax on excess contributions

Section 4973 imposes a six percent excise tax for each taxable year on HSA contributions in excess of the maximum contribution limit for the year (excess contributions). If the excess contributions for the year and the net income attributable to such excess contributions are withdrawn from the HSA before the last day (with extensions) for filing the federal income tax return for the taxable year, the amount is not subject to the excise tax for that year. However, an amount included in gross income under § 223(b)(8)(B) because an individual failed to remain an eligible individual during the testing period is not an excess contribution and § 4973 does not apply to this amount. For this reason, the amount cannot be withdrawn under the excess contribution rules.

HSA distributions not used for qualified medical expenses

An HSA distribution not used for qualified medical expenses (as defined in § 223(d)(2)) is included in gross income under § 223(f)(2) and is subject to the additional 10 percent tax under § 223(f)(4) (with certain exceptions), regardless of whether the amount contributed to the HSA under the full contribution rule is included in the account beneficiary's income and subject to the additional tax under § 223(b)(8)(B)(i). See Notice 2007–22, 2007–10 I.R.B. 670, regarding consequences of distributions from HSAs. See Example 9 below.

Establishing HSAs

An individual may establish an HSA at any time on or after the date the individual becomes HSA-eligible. Contributions for the taxable year can be made in one or more payments, at any time prior to the time (without extensions) for filing the individual's federal income tax return for the taxable year. An individual who becomes an eligible individual after January 1 may make the maximum contribution to an HSA on the first day he or she is an eligible individual. Notice 2004–2, Q&A–21. In that case, the individual's contribution is based on the individual's expected coverage on the first day of the last month of his or her taxable year. But see testing period rules above.

EXAMPLES

The following examples illustrate these rules. It is assumed in the examples that the taxable year of all individuals is the calendar year, and that, for purposes of § 223(b)(8)(B)(ii), no individuals are disabled within the meaning of § 72(m)(7) unless otherwise stated.

Example 1. Individual A, age 53, enrolls in family HDHP coverage on December 1, 2008 and is otherwise an eligible individual on that date. A is not an eligible individual in any other month in 2008.

A is an eligible individual with family HDHP coverage on December 1, 2008. A's full contribution limit under § 223(b)(8) for 2008 is $5,800. The sum of the monthly contribution limits is $483.33 (1/12 x $5,800). A's annual contribution limit for 2008 is $5,800, the greater of $5,800 or $483.33

Example 2. Same facts as *Example 1*, except that A contributes $5,800 to his HSA on December 1, 2008 and ceases to be an eligible individual in June 2009.

The testing period for 2008 HSA contributions ends on December 31, 2009. In 2009, A ceases to be an eligible individual during the testing period. In 2009, A must include in gross income $5,316.67, the amount contributed to the HSA for 2008 minus the sum of the monthly contribution limits ($5,800.00 - $483.33). In addition, the 10 percent additional tax ($531.67) in § 223(b)(8)(B)(i) applies to the amount included in gross income.

Example 3. Individual B, age 39, enrolls in self-only HDHP coverage on January 1, 2008 and is an eligible individual on that date. B's coverage changes to family HDHP coverage on November 1, 2008 and B retains family HDHP coverage through December 31, 2008. B is an eligible individual from January 1, 2008 through December 31, 2008 and remains an eligible individual through December 31, 2009.

B is an eligible individual with family HDHP coverage on December 1, 2008. B's full contribution limit under § 223(b)(8) for 2008 is $5,800. B's sum of the monthly contribution limits is $3,383.34 ((2/12 x $5,800) + (10/12 x $2,900)). B's annual contribution limit for 2008 is $5,800, the greater of $5,800 or $3,383.34.

Example 4. In 2007, Individual C, age 47, is covered by a general purpose health FSA with a grace period ending March 15, 2008. C enrolls in family HDHP coverage on January 1, 2008. C becomes an eligible individual on April 1, 2008 and remains an eligible individual through December 31, 2009. On April 2, 2008, C contributes $5,800 to his HSA for 2008.

C is an eligible individual with family HDHP coverage on December 1, 2008. C's full contribution limit under § 223(b)(8) for 2008 is $5,800. C's sum of the monthly contribution limits is $4,350 (9/12 x $5,800). C's annual contribution limit for 2008 is $5,800, the greater of $5,800 or $4,350. The testing period for 2008 ends on December 31, 2009. Because C is an eligible individual during the testing period, no amount of the $5,800 contribution is included in C's gross income and C is not subject to the 10 percent additional tax.

Example 5. Individual D, age 57, enrolls in family HDHP coverage on December 1, 2008 and is an eligible individual on that date. D was not an eligible individual in any other month in 2008. D contributes $6,700 to his HSA on December 1, 2008 and remains an eligible individual through December 31, 2009.

D is an eligible individual with family HDHP coverage on December 1, 2008 and remains an eligible individual through December 31, 2009. D's full contribution limit under § 223(b)(8) for 2008 is $6,700 ($5,800 family coverage contribution + $900 catch-up contribution). The sum of the monthly contribution limits is $558.33 ((1/12 x $5,800) + (1/12 x $900)). D's annual contribution limit for 2008 is $6,700, the greater of $6,700 or $558.33.

Example 6. Individual E, age 35, has self-only HDHP coverage and is an eligible individual for the months of May, June, and July 2008.

The full contribution limit under § 223(b)(8) does not apply to E for 2008 because E is not an eligible individual on December 1, 2008. E's contribution limit for 2008 is $725 (3/12 x $2,900).

Example 7. Individual F, age 46, enrolls in family HDHP coverage on January 1, 2008 and is an eligible individual on that date. F contributes $5,800 to an HSA on January 1, 2008. F ceases to be covered by an HDHP on August 1, 2008. On December 15, 2008, F withdraws from the HSA $2,416.67 ($5,800.00 - $3,383.33), plus $45 earnings attributable to the $2,416.67.

F ceases to be an eligible individual on August 1, 2008. The full contribution limit does not apply to F for 2008 because F is not an eligible individual on December 1, 2008, and the testing period in § 223(b)(8)(B)(i) does not apply to F. F's HSA contribution limit for 2008 is $3,383.33 (7/12 x $5,800). The $2,416.67 is an excess contribution for purposes of § 4973, but is not subject to the six percent excise tax under § 4973 because F withdrew the excess contribution and earnings attributable to the excess contribution by the due date, with extensions, for filing her 2008 federal income tax return. F reports the $45 withdrawn earnings as gross income on her 2008 federal income tax return. The gross income inclusion and 10 percent tax in § 223(f)(3) for distributions not used for qualified medical expenses in § 223(f)(2) do not apply because F withdrew an excess contribution.

Example 8. Individual G, age 38, enrolls in family HDHP coverage on January 1, 2008 and is an eligible individual on that date. G's coverage changes to self-only HDHP coverage on September 1, 2008 and he retains that coverage through December 31, 2008. G is an eligible individual for all 12 months in 2008. G contributes $4,833.33 ((8/12 x $5,800) + (4/12 x $2,900)) to an HSA for 2008. G ceases to be an eligible individual on January 1, 2009.

G is an eligible individual with self-only HDHP coverage on December 1, 2008. G's full contribution limit under § 223(b)(8) for 2008 is $2,900. G's sum of the monthly contribution limits is $4,833.33 ((8/12 x $5,800) + (4/12 x $2,900)). G's annual contribution limit is $4,833.33, the greater of $2,900 or $4,833.33. The testing period for 2008 HSA contributions ends on December 31, 2009. G ceases to be an eligible individual during the testing period. Because G's contribution of $4,833.33 is not greater than the sum of the monthly contribution limits, there is no inclusion or additional tax when G ceases to be an eligible individual during the testing period.

Example 9. Individual H, age 25, enrolls in self-only HDHP coverage on June 1, 2008 and is an eligible individual on that date. H is not an eligible individual prior to June 1, 2008. H contributes $2,900 to an HSA on July 1, 2008. H is an eligible individual on December 1, 2008, and continues to be an eligible individual until February 1, 2009. On February 2, 2009, H withdraws $1,208.33 from his HSA. The $1,208.33 distribution is not used for H's qualified medical expenses (as defined in § 223(d)(2)).

H is an eligible individual with self-only HDHP coverage on December 1, 2008. H's full contribution limit under § 223(b)(8) for 2008 is $2,900. H's sum of the monthly contribution limits is $1,691.67 (7/12 x $2,900). H's annual contribution limit is $2,900, the greater of $2,900 or $1,691.67. The testing period for 2008 HSA contributions ends on December 31, 2009. In 2009, H ceases to be an eligible individual during the testing period. In 2009, H must include in gross income $1,208.33, the amount contributed to the HSA minus the sum of the monthly contribution limits ($2,900.00 - $1,691.67). In addition, the 10 percent additional tax ($120.83) in § 223(b)(8)(B)(i) applies to the amount.

The $1,208.33 withdrawn from the HSA is not used for qualified medical expenses and is not a withdrawal of an excess contribution. Therefore, under § 223(f)(2), $1,208.33 is also included in H's gross income and is also subject to the 10 percent additional tax in § 223(f)(4). As a result, H includes $2,416.66 ($1,208.33 with respect to § 223(f)(4) and $1,208.33 with respect to § 223(b)(8)) in gross income in 2009 and an additional tax of $241.66 ($120.83 with respect to § 223(f)(4) and $120.83 with respect to § 223(b)(8)).

Example 10. Individual J, age 27, is eligible for medical benefits through the Department of Veterans Affairs (VA). As a result of medical care (other than disregarded coverage or preventive care) that J received from the VA in January 2008, he is not an eligible individual in January, February, March, or April 2008. J has self-only HDHP coverage and is otherwise an eligible individual from May 1, 2008 through December 31, 2009.

J is an eligible individual with self-only HDHP coverage on December 1, 2008. J's full contribution limit under § 223(b)(8) for 2008 is $2,900. J's sum of the monthly contribution limits is $1,933.33 (8/12 x $2,900). J's annual contribution limit for 2008 is $2,900, the greater of $2,900 or $1,933.33.

Example 11. Same facts as *Example 10*, except that J also receives medical care (other than disregarded coverage or preventive care) from the VA in October 2008. J is an eligible individual with self-only HDHP coverage in May through September 2008.

The full contribution limit does not apply to J for 2008 because J is not an eligible individual on December 1, 2008. J's 2008 contribution limit is determined under the sum of the monthly contribution limits and is $1,208.33 (5/12 x $2,900).

Example 12. Individual K, age 64, enrolls in family HDHP coverage on April 1, 2008 and is an eligible individual from April 1, 2008 through December 31, 2008. K was not an eligible individual prior to April 1, 2008. K contributes $6,700 to his HSA for 2008 on April 1, 2008. K attains age 65 and enrolls in Medicare on March 24, 2009 and ceases to be an eligible individual.

K is an eligible individual with family HDHP coverage on December 1, 2008. K's full contribution limit under § 223(b)(8) for 2008 is $6,700 ($5,800 family coverage contribution + $900 catch-up contribution). K's sum of the monthly contribution limits is $5,025 ((9/12 x $5,800) + (9/12 x $900)). K's annual contribution limit for 2008 is $6,700, the greater of $6,700 or $5,025. The testing period for 2008 HSA contributions ends on December 31, 2009. In 2009, K ceases to be an eligible individual during the testing period. In 2009, K must include $1,675, the amount contributed to the HSA minus the sum of the monthly contribution limits ($6,700.00 - $5,025.00) in gross income. In addition, the 10 percent additional tax ($167.50) in § 223(b)(8)(B)(i) applies to the amount.

Example 13. Same facts as *Example 12*, except that before enrolling in Medicare, K ceases to be an eligible individual during the testing period as a result of becoming disabled. Because K ceases to be an eligible individual due to becoming disabled, no amount is required to be included in income in 2009 or is subject to the additional tax in § 223(b)(8).

Example 14. Individuals L and M, both age 40, are a married couple. L and M enroll in family HDHP coverage on December 1, 2008 and are otherwise eligible individuals on that date. L and M are not eligible individuals in any other month in 2008. L and M divide the contribution limit equally between them. On or after December 1, 2008, L contributes $2,900 to his HSA and M contributes $2,900 to her HSA. On June 1, 2009, M switches to self-only HDHP coverage and remains an eligible individual through December 31, 2009. L ceases to be an eligible individual in June 2009.

L and M are eligible individuals with family HDHP coverage on December 1, 2008. L and M's combined full contribution limit for 2008 is $5,800. L and M's combined sum of the monthly contribution limits is $483.33 (1/12 x $5,800), or $241.67 each ((1/12 x $5,800)/2). L and M's combined annual contribution limit under § 223(b)(8) is $5,800, the greater of $5,800 or $483.33. The testing period for 2008 HSA contributions ends on December 31, 2009. During the testing period for 2008, M remains an eligible individual but L ceases to be an eligible individual. Because M is an eligible individual during the testing period, no amount of M's $2,900 contribution is included in M's gross income and M is not subject to the 10 percent additional tax. In 2008, L must include $2,658.33 in gross income, the amount contributed to the HSA minus the sum of the monthly contribution limits ($2,900 - $241.67). In addition, the 10 percent additional tax ($265.83) in § 223(b)(8)(B)(i) applies to that amount.

Example 15. Same facts as *Example 14*, except M contributes $5,800 to M's HSA and L contributes $0 to L's HSA. No amount is taxable to either L or M.

NO EFFECT ON HSA ESTABLISHMENT DATE

Expenses incurred before an HSA is established are not qualified medical expenses. Notice 2004–2, Q&A–26. Although § 223(b)(8) and this notice provide that certain individuals are treated as eligible individuals on the first day of the taxable year in determining the contribution amount, an HSA is not established before the date that the HSA is actually established. See also Notice 2007–22, 2007–10 I.R.B. 670.

REPORTING

Neither employers nor trustees are responsible for reporting whether an individual remains an eligible individual during the testing period.

EFFECTIVE DATE

Sections 223(b)(2)(A) and (B) and § 223(b)(8), allowing full contributions for months preceding the month that an individual is an eligible individual, are effective for taxable years beginning after December 31, 2006.

INTERACTION WITH § 408(d)(9)

See Notice 2008–51, also published in 2008–25 I.R.B.

EFFECT ON OTHER DOCUMENTS

Notice 2004–2 and Notice 2004–50 are modified.

DRAFTING INFORMATION

The principal author of this notice is Leslie R. Paul of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Paul at (202) 622–6080 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Declaratory Judgments — Gift Tax Determinations

REG–143716–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 7477 of the Internal Revenue Code (Code) regarding petitions filed with the United States Tax Court for declaratory judgments as to the valuation of gifts. Changes to the applicable law were made by section 506(c)(1) of the Taxpayer Relief Act of 1997 (TRA). The proposed regulations primarily affect individuals who are donors of gifts. The proposed regulations provide rules for determining whether a donor may petition the Tax Court with respect to the value of a gift, including guidance regarding the definition of "exhaustion of administrative remedies." This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by September 8, 2008. Outlines of topics to be discussed at the public hearing scheduled for October 16, 2008, must be received by September 11, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–143716–04), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–143716–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–143716–04). The public hearing will be held in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Juli Ro Kim or George Masnik, (202) 622–3090; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Kelly Banks at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Gift tax is computed by determining a tax on the total of the gifts deemed made by the donor in the year for which the return is filed (the current calendar year) plus the total of that donor's gifts in prior years (prior taxable gifts). The tax so computed is then reduced by the tax that would have been payable on the prior taxable gifts, had the tax rate for the current taxable year applied to the prior taxable gifts. The result (after taking into account the applicable credit amount under section 2505) is the gift tax on the gifts in the current calendar year. Similarly, the estate tax is computed by determining a tax on the sum of the value of the decedent's taxable estate and the value of certain taxable gifts (adjusted taxable gifts) made by the decedent prior to death. The tax computed is then reduced by the gift tax that would have been payable on the adjusted taxable gifts, had the estate tax rate applied to the adjusted taxable gifts. The result (after allowing for various credits) is the estate tax on the taxable estate.

The Taxpayer Relief Act of 1997 (TRA) (Public Law 105–34, 111 Stat. 855), the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105–206, 112 Stat. 685), and the Tax and Trade Relief Extension Act of 1998 (Public Law 105–277, 112 Stat. 2681–909), (collectively, the 1998 Acts), enacted or amended sections 2001(f), 2504(c), 6501(c)(9), and 7477, effective in the case of gifts made after August 5, 1997, to provide a degree of finality regarding the valuation of lifetime gifts for gift and estate tax purposes. Congress was concerned that the prior regime resulted in the resolution of controversies based on stale evidence, and necessitated the retention of records for unduly long periods of time. H.R. Rep. No. 105–148 at 359 (1997).

Under sections 6501(a) and (c)(9) as amended by TRA and the 1998 Acts, and the applicable regulations, if a transfer of property is adequately disclosed on a gift tax return, then the period of limitations for assessment of gift tax with regard to that transfer will commence to run on the date the return is filed. Once the time for assessment of gift tax has expired for a transfer made after August 5, 1997, the value of the gift as "finally determined" for gift tax purposes, as defined in section 2001(f), is the value to be used for purposes of determining prior taxable gifts in computing the gift tax liability in subsequent years under section 2504(c), and for purposes of determining adjusted taxable gifts in computing the estate tax liability under section 2001(f). Under §§20.2001–1(b) and 25.2504–2(b), this finality rule applies with respect to all issues that might be raised with respect to the transfer, including valuation issues and legal issues. The amount of a gift is finally determined if: (1) the amount is shown on a gift tax return and the IRS does not contest the amount before the period for assessing gift tax expires; (2) before the period for assessing gift tax expires, the amount is adjusted by the IRS and the taxpayer does not contest the adjusted amount; or, (3) the amount is determined by a court or pursuant to a settlement agreement between the taxpayer and the IRS.

Section 7477 was enacted as part of TRA in conjunction with these other provisions to provide a declaratory judgment procedure pursuant to which taxpayers may contest in the United States Tax Court an IRS determination regarding the value of a gift. See H.R. CONF. REP. NO. 105–220, at 407–408 (1997). In the absence of section 7477, without an actual gift tax deficiency, a taxpayer would be unable to petition the Tax Court to contest the determination or, without an overpayment of tax, file a claim for refund or bring suit for refund in Federal court. This

could occur, for example, if an increase in gift tax determined under section 2502 is offset by the taxpayer's applicable credit amount under section 2505(a), so that no additional tax would be assessed as a result of the valuation increase. Thus, without section 7477, such a taxpayer would be left without any way to challenge the IRS determination, even though, upon the expiration of the statute of limitations, that determination would become binding for purposes of calculating the cumulative gift tax on all future gifts of that taxpayer, as well as the taxpayer's estate tax liability.

Explanation of Provisions

Under section 7477(a), the donor may contest an IRS determination of the amount of a gift. Specifically, the donor may petition the Tax Court for a declaratory judgment, provided that certain requirements are met. Section 7477(a) applies in the case of an actual controversy involving a determination by the IRS regarding the value of a gift that is shown on the gift tax return or disclosed on the gift tax return or in a statement attached to that return.

These proposed regulations provide a procedure for pursuing a declaratory judgment in the Tax Court pursuant to section 7477 in situations where, prior to the enactment of that section, the taxpayer would have had no remedy to challenge the IRS determination. Specifically, the procedure provided by these proposed regulations applies only in those situations where an adjustment by the IRS does not result in a gift tax deficiency or refund. In situations where the IRS adjustment results in a proposed tax deficiency or a potential refund, taxpayers should not follow the procedures in these proposed regulations but should continue to follow the procedures already in place to dispute a deficiency or claim a refund. These procedures more efficiently address and resolve disputes involving a deficiency or refund.

The first requirement for eligibility for relief under section 7477 is that the transfer must be shown or disclosed "on the return of tax imposed by chapter 12," that is, a Federal gift tax return, or on a statement attached to the return. Under the proposed regulations, the return of tax imposed by chapter 12 is defined as the last gift tax return for the calendar year filed on or before the due date of the return, including extensions granted (if any), or if a timely return is not filed, the first gift tax return for the calendar year filed after the due date.

If the transfer is not shown or disclosed on the gift tax return, or on a statement attached to the return, a declaratory judgment under section 7477 is not available. If, however, a transfer is disclosed on the return or on a statement attached to the return, this eligibility requirement for the section 7477 procedure is satisfied, even if the transfer is disclosed in a manner that does not satisfy the requirements of section 6501(c)(9) and §301.6501(c)–1(e) or (f) pertaining to adequate disclosure sufficient to commence the running of the period of limitations on assessment. There may be no compelling reason for the IRS to examine a transaction that is disclosed on the return but not in a manner sufficient to trigger the running of the statute of limitations, because the time period for adjusting the value of the gift is not limited by the statute of limitations for assessments. The Treasury Department and the IRS, however, recognize that in many cases the IRS may prefer to contemporaneously resolve the transfer tax treatment of that transaction, even though the standards for adequate disclosure with regard to that transaction have not been satisfied by the donor. Thus, the IRS in its discretion may make a determination regarding the transfer and place the transfer in controversy by mailing a notice of determination of value used in unagreed cases (Letter 3569) with regard to that transfer. The ability to place a transfer that is not adequately disclosed in controversy is consistent with the Congressional purpose in enacting the TRA provisions, noted previously, to promote the early resolution of gift tax controversies based on contemporaneous evidence. The IRS and Treasury Department emphasize that the issuance of a Letter 3569 with regard to such a transfer does not constitute a determination by the IRS that the transfer was adequately disclosed or otherwise cause the period of limitations on assessment to commence to run with respect to that transfer.

Alternatively, the IRS may in its discretion decide not to put a transfer in controversy at that time (whether or not any other transfer reported on a gift tax return is then put into controversy). If the IRS decides not to put the transfer into controversy at that time, the IRS will not issue a Letter 3569 (described in this preamble) (or the Letter 3569 issued will not address that transfer), the declaratory judgment procedure will not be available for that transfer, and the limitations period applicable to that transfer will remain open.

Section 7477 also requires an actual controversy with respect to a determination by the IRS of the value of the disclosed transfer. Thus, the donor is not permitted to bypass the examination process and unilaterally seek a declaratory judgment. Generally, the IRS must propose adjustments with which the donor disagrees. Accordingly, the proposed regulations provide that, in order for the section 7477 declaratory judgment procedure to be available to a donor, the IRS must first make a determination regarding the gift tax treatment of the transfer that results in an actual controversy in a situation where the adjustments do not result in a gift tax deficiency or refund. This IRS determination is deemed to be made by the mailing of a Letter 3569 to notify the taxpayer of the adjustments proposed by the IRS. The mailing of this letter to the donor is the prerequisite for filing a petition with the Tax Court requesting a declaratory judgment under section 7477.

Section 7477 also requires that the donor's pleading seeking a declaratory judgment under section 7477 must be filed with the Tax Court before the 91st day after the mailing of the Letter 3569 by the IRS. The pleading must be in the form of a petition subject to Tax Court Rule 211(d).

Finally, section 7477(b)(2) provides that the Tax Court may not issue a declaratory judgment under section 7477 unless it first determines that the donor has exhausted all administrative remedies available to the donor within the IRS with respect to the controversy. Tax Court Rule 211(d) requires that the petition in an action under section 7477 must contain a statement that the petitioner has exhausted all administrative remedies within the IRS. See also Tax Court Rule 210(c)(4). Accordingly, the proposed regulations set forth the administrative remedies available to the donor with respect to a determination by the IRS of the amount of a gift, and the circumstances in which the IRS will not contest the donor's allegation that administrative remedies have been exhausted. The administrative remedies are

intended to parallel those applicable in the case of an asserted gift tax deficiency.

Specifically, the proposed regulations provide that the IRS will not contest the donor's allegation that the donor's administrative remedies have been exhausted if: (1) the donor requests Appeals consideration in writing within 30 calendar days after the mailing date of a notice of preliminary determination of value (Preliminary Determination Letter) from the IRS, or by such later date for responding to the Preliminary Determination Letter as determined pursuant to IRS procedures; (2) the donor participates fully in the Appeals consideration process, including without limitation timely submitting all additional information related to the amount of the gift that is requested by the IRS in connection with (or as a follow-up to) the Appeals consideration process; and (3) the IRS mails to the donor the Letter 3569, which will notify the donor of the proposed adjustments and of the donor's right to contest the determination by filing a petition for declaratory judgment with the Tax Court before the 91st day after the date of mailing the Letter 3569. The Letter 3569 usually will be issued by the Appeals office. However, because section 7477 requires that the Tax Court, rather than the IRS, determine whether the donor has exhausted all administrative remedies, the donor generally will be sent a Letter 3569 in those situations where the donor does not respond to the Preliminary Determination Letter, or expressly declines to participate in the Appeals process. If a donor does not respond to a Preliminary Determination Letter, or if a donor does not participate in the Appeals process, the IRS will consider the donor to have failed to exhaust administrative remedies. In such cases, the IRS may challenge any allegation in the donor's petition for a section 7477 declaratory judgment that the donor has exhausted all administrative remedies.

The proposed regulations also provide that the IRS will not contest the donor's allegation that all administrative remedies have been exhausted in certain circumstances where the above-described process is not followed by the IRS. (For example, the IRS might mail a Letter 3569 to the donor in the absence of these other preliminary steps where, because of the imminent expiration of the applicable statute of limitations, the IRS believes there is not sufficient time to issue a Preliminary Determination Letter to allow Appeals consideration). If the IRS's decision not to issue a Preliminary Determination Letter is not due to the donor's actions or failure to act, the IRS will not contend that the donor failed to exhaust all administrative remedies, provided that the donor fully participates in the Appeals consideration process offered by the IRS during the pendancy of the Tax Court proceeding. In this regard, the IRS and Treasury Department do not view the reference to section 7477 contained in §601.106(a)(2)(iv) of the Statement of Procedural Rules as currently in effect and Rev. Proc. 87–24, 1987–1 C.B. 720, as prohibiting Appeals' jurisdiction to consider docketed cases under current section 7477. The version of section 7477 referenced in those items was repealed prior to the enactment of the current section 7477 as part of the TRA.

The proposed regulations confirm that the donor is not required to consent to an extension of the time within which gift tax with respect to the transfer at issue may be assessed in order to exhaust the donor's administrative remedies, and that the failure to consent to such an extension will not be taken into account for this purpose. See section 7430(b)(1) and *Minahan v. Commissioner*, 88 T.C. 492 (1987), considering this issue in the context of section 7430(b)(1) prior to amendment by Public Law 104–168 (110 Stat. 1452).

Under the proposed regulations, a donor may petition for a declaratory judgment with respect to disputes regarding valuation and/or other related issues. This is consistent with §§20.2001–1(b) and 25.2504–2(b) providing that, once the gift tax statute of limitations has expired with respect to a transfer, the IRS is precluded from making any adjustments with respect to that transfer for purposes of determining prior taxable gifts or adjusted taxable gifts, regardless of whether the adjustment involves a valuation issue or a legal issue pertaining to the proper interpretation of the gift tax law. See also §301.6501(c)–1(f)(5) providing a similar rule regarding transfers that are incomplete gifts but are reported as completed gifts. Accordingly, even if a gift tax adjustment does not generate any additional gift tax liability, the IRS nevertheless is required to propose the adjustment (and to take all other necessary steps) in order to challenge the return as filed within the statutory limitations period, regardless of the nature of the issue presented. Sections 2001(f), 2504(c), 6501(c)(9) and 7477, as enacted or amended by TRA and the 1998 Acts, provide an integrated statutory regime pursuant to which taxpayers are accorded finality with respect to adequately disclosed transfers (except for transfers that are reported as incomplete gifts), while the IRS is afforded the reasonable opportunity to identify in a timely manner returns that present issues that merit further examination. The section 7477 declaratory judgment procedure is a necessary part of this regime because it provides a mechanism to finally resolve any disputed adjustments in circumstances where there is no tax assessment and thus the donor would otherwise be unable to satisfy the jurisdictional requirements for any judicial resolution. The IRS and Treasury Department believe it is appropriate for the declaratory judgment mechanism under section 7477, when available in circumstances where there is no deficiency or refund, to be available for all adjustments regardless of whether the basis for those adjustments is factual, legal, or both.

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 these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this regulation has been submitted to the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the pro-

posed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 16, 2008 at 10:00 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble. The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments by September 8, 2008, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 11, 2008.

A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Juli Ro Kim, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. Other personnel from the IRS and the Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.7477–1 is revised to read as follows:

§301.7477–1 Declaratory Judgments relating to the value of certain gifts for gift tax purposes.

(a) *In general*. If the requirements contained in paragraph (d) of this section are satisfied, a donor may petition the United States Tax Court under section 7477 for a declaratory judgment regarding the amount of one or more of the donor's gifts during the calendar year for Federal gift tax purposes, if the adjustment(s) proposed by the Internal Revenue Service (IRS) will not result in any deficiency in or refund of the donor's gift tax liability for that calendar year.

(b) *Declaratory judgment procedure*—(1) *In general*. If a donor does not resolve a dispute with the IRS concerning the value of a transfer for gift tax purposes at the Examination level, the donor will be sent a notice of preliminary determination of value, or such other document as may be utilized by the IRS for this purpose from time to time, but referred to in this section as a Preliminary Determination Letter, inviting the donor to file a formal protest and to request consideration by the appropriate IRS Appeals office. See §§601.105 and 601.106 of this chapter. Subsequently, the donor will be sent a notice of determination of value (Letter 3569, or such other document as may be utilized from time to time by the IRS for this purpose in cases where no deficiency or refund would result, but referred to in this section as Letter 3569) if—

(i) The donor requests Appeals consideration in writing within 30 calendar days after the mailing date of the Preliminary Determination Letter, or by such later date as determined pursuant to IRS procedures, and the matter is not resolved by Appeals;

(ii) The donor does not request Appeals consideration within the time provided in paragraph (b)(1)(i) of this section; or

(iii) The IRS does not issue a Preliminary Determination Letter in circumstances described in paragraph (d)(3)(ii) of this section.

(2) *Notice of determination of value*. The Letter 3569 will notify the donor of the adjustment(s) proposed by the IRS, and will advise the donor that the donor may contest the determination made by the IRS by filing a petition with the Tax Court before the 91st day after the date on which the Letter 3569 was mailed to the donor by the IRS.

(3) *Tax Court petition*. If the donor does not file a timely petition with the Tax Court, the IRS determination as set forth in the Letter 3569 will be considered the final determination of value, as defined in sections 2504(c) and 2001(f). If the donor files a timely petition with the Tax Court, the Tax Court will determine whether the donor has exhausted available administrative remedies. Under section 7477, the Tax Court is not authorized to issue a declaratory judgment unless the Tax Court finds that the donor has exhausted all administrative remedies within the IRS. See paragraph (d)(3) of this section regarding the exhaustion of administrative remedies.

(c) *Adjustments subject to declaratory judgment procedure*. The declaratory judgment procedures set forth in this section apply to adjustments involving all issues relating to the transfer, including without limitation valuation issues and legal issues involving the interpretation and application of the gift tax law.

(d) *Requirements for declaratory judgment procedure*. The declaratory judgment procedure provided in this section is available to a donor with respect to a transfer only if the requirements of paragraphs (d)(1) through (4) of this section with regard to that transfer are satisfied.

(1) *Reporting*. The transfer is shown or disclosed on the return of tax imposed by chapter 12 for the calendar year during which the transfer was made or on a statement attached to such return. For purposes of this paragraph, the term return of tax imposed by chapter 12 means the last gift tax return (Form 709, "*United States Gift (and Generation-Skipping Transfer) Tax Return*," or such other form as may be utilized for this purpose from time to time by the IRS) for the calendar year filed on or before the due date of the return, including extensions granted if any, or, if a timely return is not filed, the first gift tax return for that calendar year filed after the due date. For purposes of satisfying this requirement, the transfer need not be reported in a manner that constitutes adequate disclosure within the meaning of §301.6501(c)–1(e) or (f) (and thus for which, under §§20.2001–1(b) and 25.2504–2(b) of this chapter, the period

will not expire during which the IRS may adjust the value of the gift). The issuance of a Letter 3569 with regard to a transfer disclosed on a return does not constitute a determination by the IRS that the transfer was adequately disclosed, or otherwise cause the period of limitations on assessment to commence to run with respect to that transfer. In addition, in the case of a transfer that is shown on the return, the IRS may in its discretion choose to defer until a later time making a determination with regard to such transfer. If the IRS exercises its discretion to defer such determination in that case, the transfer will not be addressed in the Letter 3569 (if any) sent to the donor currently, and the donor is not yet eligible for a declaratory judgment with regard to that transfer under section 7477.

(2) *IRS determination and actual controversy*. The IRS makes a determination regarding the gift tax treatment of the transfer that results in an actual controversy. The IRS makes a determination that results in an actual controversy with respect to a transfer by mailing a Letter 3569 to the donor, thereby notifying the donor of the adjustment(s) proposed by the IRS with regard to that transfer and of the donor's rights under section 7477.

(3) *Exhaustion of administrative remedies*—(i) *In general — Appeals office consideration*. The Tax Court determines that the donor has exhausted all administrative remedies available within the IRS for resolving the controversy. For purposes of this section, the IRS will consider a donor to have exhausted all administrative remedies if, prior to filing a petition in Tax Court (except as provided in paragraph (d)(3)(ii) of this section), the donor, or a qualified representative of the donor described in §601.502 of this chapter, timely requests consideration by Appeals and participates fully in the Appeals consideration process, including, without limitation, timely submitting all information related to the transfer that is requested by the IRS in connection with the Appeals consideration. A timely request for consideration by Appeals is a written request from the donor for Appeals consideration made within 30 days after the mailing date of the Preliminary Determination Letter, or by such later date for responding to the Preliminary Determination Letter as is agreed to between the donor and the IRS.

(ii) *No Preliminary Determination Letter issued*. If the IRS does not issue a Preliminary Determination Letter to the donor prior to the issuance of Letter 3569, the IRS nevertheless will consider the donor to have exhausted all administrative remedies within the IRS for purposes of section 7477 upon the issuance of the Letter 3569, provided that—

(A) The IRS decision not to issue the Preliminary Determination Letter was not due to actions or inactions of the donor (such as a failure to supply requested information or a current mailing address to the Area Director having jurisdiction over the tax matter); and

(B) The donor, or a qualified representative of the donor described in §601.502 of this chapter, after the filing of a petition in Tax Court for a declaratory judgment pursuant to section 7477, fully participates (within the meaning of paragraph (d)(3)(i) of this section) in the Appeals office consideration when offered by the IRS while the case is in docketed status.

(iii) *Failure to agree to extension of time for assessment*. The donor has the right to agree (or to decline to agree) to an extension of the time under section 6501 within which gift tax with respect to the transfer at issue may be assessed. For purposes of section 7477, the donor's refusal to agree to such an extension will not be considered by the IRS to constitute a failure by the donor to exhaust all administrative remedies available to the donor within the IRS.

(4) *Timely petition in Tax Court*. The donor files a pleading with the Tax Court requesting a declaratory judgment under section 7477. This pleading must be filed with the Tax Court before the 91st day after the date of mailing of the Letter 3569 by the IRS to the donor. The pleading must be in the form of a petition subject to Tax Court Rule 211(d).

(e) *Examples*. The following examples illustrate the provisions of this section. These examples, however, do not address any other situations that might affect the Tax Court's jurisdiction over the proceeding. The examples read as follows:

Example 1. Exhaustion of administrative remedies. The donor (D) timely files a Form 709, "*United States Gift (and Generation-Skipping Transfer) Tax Return*," on which D reports D's completed gift of closely held stock. After conducting an examination, the IRS concludes that the value of the stock on the date of the gift is greater than the value reported on the return. Because the amount of D's available applicable credit amount under section 2505 is sufficient to cover any resulting tax liability, no gift tax deficiency will result from the adjustment. D is unable to resolve the matter with the IRS examiner. The IRS sends a notice of preliminary determination of value (Preliminary Determination Letter) to D informing D of the proposed adjustment. D, within 30 calendar days after the mailing date of the letter, submits a written request for Appeals consideration. During the Appeals process, D provides to the Appeals office all additional information (if any) requested by Appeals relevant to the determination of the value of the stock in a timely fashion. The Appeals office and D are unable to reach an agreement regarding the value of the stock as of the date of the gift. The Appeals office sends D a notice of determination of value (Letter 3569). For purposes of section 7477, the IRS will consider D to have exhausted all available administrative remedies within the IRS, and thus will not contest the allegation in D's petition that D has exhausted all such administrative remedies.

Example 2. Exhaustion of administrative remedies. Assume the same facts as in *Example 1*, except that D does not timely request consideration by Appeals after receiving the Preliminary Determination Letter. A Letter 3569 is mailed to D more than 30 days after the mailing of the Preliminary Determination Letter and prior to the expiration of the period of limitations for assessment of gift tax. D timely files a petition in Tax Court pursuant to section 7477. After the case is docketed, D requests Appeals consideration. In this situation, because D did not respond timely to the Preliminary Determination Letter with a written request for Appeals consideration, the IRS will not consider D to have exhausted all administrative remedies available within the IRS for purposes of section 7477 prior to filing the petition in Tax Court, and thus may contest any allegation in D's petition that D has exhausted all such administrative remedies.

Example 3. Exhaustion of administrative remedies. D timely files a Form 709 on which D reports D's completed gifts of interests in a family limited partnership. After conducting an examination, the IRS proposes to adjust the value of the gift as reported on the return. No gift tax deficiency will result from the adjustments, however, because D has a sufficient amount of available applicable credit amount under section 2505. D declines to consent to extend the time for the assessment of gift tax with respect to the gifts at issue. Because of the pending expiration of the period of limitation on assessment with respect to the gifts, the IRS determines that there is not adequate time for Appeals consideration. Accordingly, the IRS mails to D a Letter 3569, even though a Preliminary Determination Letter had not first been issued to D. D timely files a petition in Tax Court pursuant to section 7477. After the case is docketed in Tax Court, D is offered the opportunity for Appeals to consider any dispute regarding the determination and participates fully in the Appeals consideration process. However, the Appeals office and D are unable to resolve the issue. The IRS will consider D to have exhausted all administrative remedies available within the IRS, and thus will not assert that D has not exhausted all such administrative remedies.

Example 4. Legal issue. In 2006, D transfers nonvested stock options to a trust for the benefit of D's child. D timely files a Form 709 reporting the trans-

fer as a completed gift for Federal gift tax purposes and complies with the adequate disclosure requirements for purposes of triggering the commencement of the applicable statute of limitations. Pursuant to §301.6501(c)–1(f)(5), adequate disclosure of a transfer that is reported as a completed gift on the Form 709 will commence the running of the period of limitations for assessment of gift tax on D, even if the transfer is ultimately determined to be an incomplete gift for purposes of §25.2511–2 of this chapter. After conducting an examination, the IRS concurs with the reported valuation of the stock options, but concludes that the reported transfer is not a completed gift for Federal gift tax purposes. D is unable to resolve the matter with the IRS examiner. Assuming that the IRS mails to D a Letter 3569 with regard to this transfer, and that D complies with the administrative procedures set forth in this section, including the exhaustion of all administrative remedies available within the IRS, then D may file a petition for declaratory judgment with the Tax Court pursuant to section 7477.

Example 5. *Transfers in controversy*. On April 16, 2007, D timely files a Form 709 on which D reports gifts made in 2006 of fractional interests in certain real property and of interests in a family limited partnership (FLP). However, although the gifts are disclosed on the return, the return does not contain information sufficient to constitute adequate disclosure under §301.6501(c)–1(e) or (f) for purposes of the application of the statute of limitations on assessment of gift tax with respect to the reported gifts. The IRS conducts an examination and concludes that the value of both the interests in the real property and the FLP interests on the date(s) of the transfers are greater than the values reported on the return. No gift tax deficiency will result from the adjustments because D has a sufficient amount of remaining applicable credit amount under section 2505. However, D does not agree with the adjustments. The IRS sends a Preliminary Determination Letter to D informing D of the proposed adjustments in the value of the reported gifts. D, within 30 calendar days after the mailing date of the letter, submits a written request for Appeals consideration. The Appeals office and D are unable to reach an agreement regarding the value of any of the gifts. In the exercise of its discretion, the IRS decides to resolve currently only the value of the real property interests, and to defer the resolution of the value of the FLP interests. On May 28, 2009, the Appeals office sends D a Letter 3569 addressing only the value of the gifts of interests in the real property. Because none of the gifts reported on the return filed on April 16, 2007, were adequately disclosed for purposes of §301.6501(c)–1(e) or (f), the period of limitations during which the IRS may adjust the value of those gifts has not begun to run. Accordingly, the Letter 3569 is timely mailed. If D timely files a petition in Tax Court pursuant to section 7477 with regard to the value of the interests in the real property, then, assuming the other requirements of section 7477 are satisfied with regard to those interests, the Tax Court's declaratory judgment, once it becomes final, will determine the value of the gifts of the interests in the real property. Because the IRS has not yet put the gift tax value of the interests in the FLP into controversy, the procedure under section 7477 is not available with regard to those gifts.

(d) *Effective/applicability date*. This section applies to civil proceedings described in section 7477 filed in the United States Tax Court on or after the date these regulations are published as final regulations in the **Federal Register**.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on June 6, 2008, 8:45 a.m., and published in the issue of the Federal Register for June 9, 2008, 73 F.R. 32503)

Notice of Proposed Rulemaking

Qualified Nonpersonal Use Vehicles

REG–106897–08

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to qualified nonpersonal use vehicles as defined in section 274(i). Qualified nonpersonal use vehicles are excepted from the substantiation requirements of section 274(d)(4) that apply to listed property as defined in section 280F(d)(4). These proposed regulations would add clearly marked public safety officer vehicles as a new type of qualified nonpersonal use vehicle. These proposed regulations would affect employers that provide their employees with qualified nonpersonal use vehicles and the employees who use such vehicles.

DATES: Written or electronic comments and requests for a public hearing must be received by September 8, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–106897–08), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8:00 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–106897–08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Additionally, taxpayers may submit electronic comments directly via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–106897–08).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Don Parkinson or Selvan Boominathan at (202) 622–6040; concerning the submission of comments or requests for a hearing, Kelly Banks at (202) 622–3628 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed Income Tax Regulations under section 274(i) added by section 2(b) of Public Law 99–44 (May 24, 1985), which provides a definition of qualified nonpersonal use vehicle. Temporary Regulation §1.274–5T(k), identifying categories of qualified nonpersonal use vehicles, was issued in T.D. 8061, 1985–2 C.B. 93 (1985). A notice of proposed rulemaking (LR–145–84, 1985–2 C.B. 809) was issued by cross-reference to Temporary Regulation §1.274–5T(k) (50 FR 46088, 1985–2 C.B. 809 (1985)). These proposed regulations incorporate the text of §1.274–5T(k) and add clearly marked public safety officer vehicles as a new type of qualified nonpersonal use vehicle, listed along with clearly marked police and fire vehicles at §1.274–5(k)(2)(ii)(A). Clearly marked public safety officer vehicles are added to the definition of clearly marked police and fire vehicles at §1.274–5(k)(3), and an example is added at §1.274–5(k)(8). (See §601.601(d)(2)(ii)(*b*).)

Explanation of Provisions

Section 274(d) provides that a taxpayer is not allowed a deduction or credit for certain expenses unless the expense is substantiated. These substantiation requirements apply to expenses incurred in the use of any listed property (defined in section 280F(d)(4)), which includes any passenger automobile and any other property used as a means of transportation. Section 274(d) does not apply to any qualified nonpersonal use vehicle as defined in section 274(i).

Section 274(i) provides that a qualified nonpersonal use vehicle is any vehicle which by reason of its nature is not likely to be used more than a *de minimis* amount for personal uses. The legislative history to section 274(i) provided a list of qualified nonpersonal use vehicles and identified a number of examples of qualified nonpersonal use vehicles such as school buses, qualified specialized utility repair trucks, and qualified moving vans. The legislative history indicated that Congress wanted the Commissioner to expand the list to include other vehicles appropriate for listing because by their nature it is highly unlikely that they will be used more than a very minimal amount for personal purposes. H.R. Rep. No. 99–34, at 11 (1985).

Passenger automobiles such as sedans and sport utility vehicles are generally not exempt from taxation as qualified nonpersonal use vehicles because by design they can easily be used for personal purposes. However, unmarked law enforcement vehicles and clearly marked police and fire vehicles are included in the list of qualified nonpersonal use vehicles set forth in the legislative history to section 274(i) and incorporated into the proposed and temporary regulations.

The IRS and the Treasury Department have become aware of a need for an additional category of vehicles to be included in the list of qualified nonpersonal use vehicles. Clearly marked vehicles provided to Federal, state and local government workers who respond to emergency situations do not satisfy the current regulations governing qualified nonpersonal use vehicles if the individual workers are not employed by either the fire department or police department. Accordingly, the proposed regulations add clearly marked public safety officer vehicles to the list of qualified nonpersonal use vehicles so that emergency responders receive the same treatment whether they work for the police department, fire department or another department of state or local government.

A clearly marked public safety officer vehicle is a vehicle owned or leased by a governmental unit or any agency or instrumentality thereof, that is required to be used for commuting by a public safety officer as defined in section 402(l)(4)(C) who, when not on a regular shift, is on call at all times, provided that any personal use (other than commuting) of the vehicle outside the limit of the public safety officer's obligation to respond to an emergency is prohibited by such governmental unit. A public safety officer vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a public safety officer vehicle.

Section 402(l)(4)(C) provides that the term "public safety officer" shall have the same meaning given such term by the Omnibus Crime Control and Safe Streets Act of 1968, as codified at 42 U.S.C. section 3796b(9)(A). 42 U.S.C. Section 3796b(9)(A) defines public safety officer as "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."

Proposed §1.274–5(k) and (l) provide a list of qualified nonpersonal use vehicles and related definitions. Section 1.274–5(k) and (l) were originally proposed in 1985 (LR–145–84, 50 FR 46088, November 6, 1985) and simultaneously issued as a temporary regulation (T.D. 8061, 50 FR 46006, November 6, 1985). Paragraph (k) of LR–145–84 is being re-proposed, with amendments, as part of these proposed regulations. Paragraph (l) provides definitions of the terms "automobile," "vehicle," "employer," "employee," and "personal use." Paragraph (l) is being re-proposed, with no changes, as part of these proposed regulations. The corresponding provisions of the proposed regulations in LR–145–84 are withdrawn upon publication of this notice. The corresponding provisions of the temporary regulations in T.D. 8061 will be withdrawn once these proposed regulations are published as final regulations in the **Federal Register**.

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 is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations do not require a collection of information and do not impose any new or different requirements on small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking has been submitted to the Chief Council for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearings

Before these proposed amendments are adopted, consideration will be given to any written comments that are submitted to CC:PA:LPD:PR (REG–106897–08). All comments will be available for public inspection and copying. A public hearing will be scheduled and held upon written request by any person who submits written comments on the proposed regulation. Notice of the time and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Don E. Parkinson and Selvan V. Boominathan, Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.132–5 paragraph (h) is amended to read as follows:

§1.132–5 Working condition fringes.

* * * * *

(h) *Qualified nonpersonal use vehicles*—(1) *In general*. Except as provided in paragraph (h)(2) of this section, 100

percent of the value of the use of a qualified nonpersonal use vehicle (as described in §1.274–5(k)) is excluded from gross income as a working condition fringe, provided that, in the case of a vehicle described in §1.274–5(k)(3) through (8), the use of the vehicle conforms to the requirements of that paragraph.

(2) *Shared usage of qualified nonpersonal use vehicles.* In general, a working condition fringe under this paragraph (h) is available to the driver and all passengers of a qualified nonpersonal use vehicle. However, a working condition fringe under this paragraph (h) is available only with respect to the driver and not with respect to any passengers of a qualified nonpersonal use vehicle described in §1.274–5(k)(2)(ii)(L) or (P).

* * * * *

Par. 3. Section 1.274–5 paragraphs (k) and (l) and the last sentence of paragraph (m) are revised to read as follows:

§1.274–5 Substantiation Requirements.

* * * * *

(k) *Exceptions for qualified nonpersonal use vehicles*—(1) *In general.* The substantiation requirements of section 274(d) and this section do not apply to any qualified nonpersonal use vehicle (as defined in paragraph (k)(2) of this section).

(2) *Qualified nonpersonal use vehicle*—(i) *In general.* For purposes of section 274(d) and this section, the term *qualified nonpersonal use vehicle* means any vehicle which, by reason of its nature (that is, design), is not likely to be used more than a *de minimis* amount for personal purposes.

(ii) *List of vehicles.* Vehicles which are qualified nonpersonal use vehicles include the following:

(A) Clearly marked police, fire, and public safety officer vehicles (as defined and to the extent provided in paragraph (k)(3) of this section).

(B) Ambulances used as such or hearses used as such.

(C) Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds.

(D) Bucket trucks (cherry pickers).

(E) Cement mixers.

(F) Combines.

(G) Cranes and derricks.

(H) Delivery trucks with seating only for the driver, or only for the driver plus a folding jump seat.

(I) Dump trucks (including garbage trucks).

(J) Flatbed trucks.

(K) Forklifts.

(L) Passenger buses used as such with a capacity of at least 20 passengers.

(M) Qualified moving vans (as defined in paragraph (k)(4) of this section).

(N) Qualified specialized utility repair trucks (as defined in paragraph (k)(5) of this section).

(O) Refrigerated trucks.

(P) School buses (as defined in section 4221(d)(7)(c).

(Q) Tractors and other special purpose farm vehicles.

(R) Unmarked vehicles used by law enforcement officers (as defined in paragraph (k)(6) of this section) if the use is officially authorized.

(S) Such other vehicles as the Commissioner may designate.

(3) *Clearly marked police, fire, or public safety officer vehicles.* A police, fire, or public safety officer vehicle is a vehicle, owned or leased by a governmental unit, or any agency or instrumentality thereof, that is required to be used for commuting by a police officer, fire fighter, or public safety officer (as defined in §402(l)(4)(C)) of this chapter who, when not on a regular shift, is on call at all times, provided that any personal use (other than commuting) of the vehicle outside the limit of the police officer's arrest powers or the fire fighter's or public safety officer's obligation to respond to an emergency is prohibited by such governmental unit. A police, fire, or public safety officer vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a police, fire, or public safety officer vehicle. A marking on a license plate is not a clear marking for purposes of this paragraph (k).

(4) *Qualified moving van.* The term *qualified moving van* means any truck or van used by a professional moving company in the trade or business of moving household or business goods if—

(i) No personal use of the van is allowed other than for travel to and from a move site (or for *de minimis* personal use, such as a stop for lunch on the way between two move sites);

(ii) Personal use for travel to and from a move site is an irregular practice (that is, not more than five times a month on average); and

(iii) Personal use is limited to situations in which it is more convenient to the employer, because of the location of the employee's residence in relation to the location of the move site, for the van not to be returned to the employer's business location.

(5) *Qualified specialized utility repair truck.* The term *qualified specialized utility repair truck* means any truck (not including a van or pickup truck) specifically designed and used to carry heavy tools, testing equipment, or parts if—

(i) The shelves, racks, or other permanent interior construction which has been installed to carry and store such heavy items is such that it is unlikely that the truck will be used more than a *de minimis* amount for personal purposes; and

(ii) The employer requires the employee to drive the truck home in order to be able to respond in emergency situations for purposes of restoring or maintaining electricity, gas, telephone, water, sewer, or steam utility services.

(6) *Unmarked law enforcement vehicles*—(i) *In general.* The substantiation requirements of section 274(d) and this section do not apply to officially authorized uses of an unmarked vehicle by a "law enforcement officer". To qualify for this exception, any personal use must be authorized by the Federal, State, county, or local governmental agency or department that owns or leases the vehicle and employs the officer, and must be incident to law-enforcement functions, such as being able to report directly from home to a stakeout or surveillance site, or to an emergency situation. Use of an unmarked vehicle for vacation or recreation trips cannot qualify as an authorized use.

(ii) *Law enforcement officer.* The term *law enforcement officer* means an individual who is employed on a full-time basis by a governmental unit that is responsible for the prevention or investigation of crime involving injury to persons or property (including apprehension or detention of persons for such crimes), who is authorized by law to carry firearms, execute search warrants, and to make arrests (other than merely a citizen's arrest), and who regularly carries firearms (except when it is not

possible to do so because of the requirements of undercover work). The term "law enforcement officer" may include an arson investigator if the investigator otherwise meets the requirements of this paragraph (k)(6)(ii), but does not include Internal Revenue Service special agents.

(7) *Trucks and vans.* The substantiation requirements of section 274(d) and this section apply generally to any pickup truck or van, unless the truck or van has been specially modified with the result that it is not likely to be used more than a *de minimis* amount for personal purposes. For example, a van that has only a front bench for seating, in which permanent shelving that fills most of the cargo area has been installed, that constantly carries merchandise or equipment, and that has been specially painted with advertising or the company's name, is a vehicle not likely to be used more than a *de minimis* amount for personal purposes.

(8) *Examples.* The following examples illustrate the provisions of paragraph (k)(3) and (6) of this section:

Example 1. Detective C, who is a "law enforcement officer" employed by a state police department, headquartered in City M, is provided with an unmarked vehicle (equipped with radio communication) for use during off-duty hours because C must be able to communicate with headquarters and be available for duty at any time (for example, to report to a surveillance or crime site). The police department generally has officially authorized personal use of the vehicle by C but has prohibited use of the vehicle for recreational purposes or for personal purposes outside the state. Thus, C's use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands is authorized personal use as described in paragraph (k)(6)(i) of this section. With respect to these authorized uses, the vehicle is not subject to the substantiation requirements of section 274(d) and the value of these uses is not included in C's gross income.

Example 2. Detective T is a "law enforcement officer" employed by City M. T is authorized to make arrests only within M's city limits. T, along with all other officers of the force, is ordinarily on duty for eight hours each work day and on call during the other sixteen hours. T is provided with the use of a clearly marked police vehicle in which T is required to commute to his home in City M. The police department's official policy regarding marked police vehicles prohibits personal use (other than commuting) of the vehicles outside the city limits. When not using the vehicle on the job, T uses the vehicle only for commuting, personal errands on the way between work and home, and personal errands within City M. All use of the vehicle by T conforms to the requirements of paragraph (k)(3) of this section. Therefore, the value of that use is excluded from T's gross income as a working condition fringe and the vehicle is not subject to the substantiation requirements of section 274(d).

Example 3. Director C is employed by City M as the director of the City's rescue squad and is provided with a vehicle for use in responding to emergencies. The city's rescue squad is not a part of City M's police or fire departments. The director's vehicle is a sedan which is painted with insignia and words identifying the vehicle as a being owned by the City's rescue squad. C, when not on a regular shift, is on call at all times. The City's official policy regarding clearly marked public safety officer vehicles prohibits personal use (other than for commuting) of the vehicle outside of the limits of the public safety officer's obligation to respond to an emergency. When not using the vehicle to respond to emergencies, City M authorizes C to use the vehicle only for commuting, personal errands on the way between work and home, and personal errands within the limits of C's obligation to respond to emergencies. With respect to these authorized uses, the vehicle is not subject to the substantiation requirements of section 274(d) and the value of these uses is not includable in C's gross income.

(l) *Definitions*. For purposes of section 274(d) and this section, the terms *automobile* and *vehicle* have the same meanings as prescribed in §§1.61–21(d)(1)(ii) and 1.61–21(e)(2), respectively. Also, for purposes of section 274(d) and this section, the terms *employer*, *employee* and *personal use* have the same meanings as prescribed in §1.274–6T(e).

(m) * * * However, paragraph (j)(3) of this section applies to expenses paid or incurred after September 30, 2002, and paragraph (k) applies to clearly marked public safety officer vehicles, as defined in §1.274–5(k)(3), only with respect to uses occurring after January 1, 2009.

Par. 4. Section 1.274–5T is revised by amending paragraph (k) and (l) as follows:

§1.274–5T Substantiation requirements (temporary).

* * * * *

(k) and (l) [Reserved]. For further guidance, see §§1.274–5(k) and (l).

* * * * *

Par. 5. Section 1.280F–6 is amended by revising paragraph (b)(2)(ii) to read:

§1.280F–6 Special rules and definitions.

* * * * *

(b) * * *

(2) * * *

(ii) *Exception.* The term "listed property" does not include any vehicle that is a qualified nonpersonal use vehicle as defined in section 274(i) and §1.274–5(k).

* * * * *

Steven Miller,
Acting Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on June 6, 2008, 8:45 a.m., and published in the issue of the Federal Register for June 9, 2008, 73 F.R. 32500)

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

Announcement 2008–55

The Internal Revenue Service has revoked its determination that the organizations listed below qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Internal Revenue Code of 1986.

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

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on June 23, 2008, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions

of the organization that were the basis for revocation.

Texas Reinvestment Corporation II
San Antonio, TX
Zebra Project, Inc.
Atlanta, GA
Alliance for Science Health and Environment, Inc.
Melbourne Beach, FL
Gymfest, Inc.
West Seneca, NY
Estrellas Nacientes, Inc.
New York, NY
Dunardry Heritage Association
Rickman, TN
Students Are For Education, Inc.
Tallahassee, FL

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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