

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2005-15, page 720.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning April 1, 2005, will be 6 percent for overpayments (5 percent in the case of a corporation), 6 percent for underpayments, and 8 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 will be 3.5 percent.

T.D. 9179, page 707.

Final regulations under section 263A of the Code except interest expense incurred by a lessor in certain safe harbor leasing transactions from the requirement to capitalize interest.

T.D. 9180, page 714.

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

T.D. 9182, page 713.

Final regulations under section 368 of the Code provide that a continuity of the business enterprise and a continuity of interest are not required for the transaction to qualify as a reorganization under section 368(a)(1)(E) or (F). Rev. Ruls. 69-516, 77-415, 77-479, and 82-34 obsolete.

REG-131128-04, page 733.

Proposed regulations under section 1502 of the Code provide guidance regarding the manner in which the intercompany items of a liquidating corporation are succeeded to and taken into account in cases where more than one distributee member acquires the assets of the liquidating corporation in a complete liquidation to which section 332 applies. The regulations also provide guidance regarding the manner in which more than one distributee member succeeds to the items (including the items described in section 381(c)) of the liquidating corporation.

Notice 2005-21, page 727.

Sections 936 and 30A of the Code provide, subject to certain limitations and conditions, special tax credits for taxable income of a domestic corporation derived from the active conduct of a trade or business in a possession of the United States. Pursuant to sections 936(j) and 30A(h), the tax credits provided by sections 936 and 30A will not be allowed for taxable years beginning after December 31, 2005. This notice provides guidance, based on existing provisions of the Code and Treasury regulations, with respect to issues that are likely to arise in connection with the termination of sections 936 and 30A.

Announcement 2005-19, page 744.

This document sets forth a settlement initiative to resolve transactions that are the same as or substantially similar to those described in Notice 2003-47, 2003-2 C.B. 132. These transactions generally involved executives transferring compensatory stock options or restricted stock to a related person in exchange for a long-term, unsecured deferred payment obligation. Taxpayers have until May 23, 2005, to notify the Service of their intent to participate in the settlement initiative.

(Continued on the next page)

Announcements of Disbarments and Suspensions begin on page 738.
Finding Lists begin on page ii.



GIFT TAX

T.D. 9181, page 717.

Final regulations under section 2702 of the Code provide guidance in two specific situations relating to qualified interests. The first situation is where the grantor retains an interest payable to the grantor for a term of years, or to the grantor's estate if the grantor dies prior to the expiration of the term. The second situation is where the grantor has a power to revoke a qualified interest of the grantor's spouse.

ADMINISTRATIVE

T.D. 9178, page 708.

Final regulations under section 301 (5 USC) of the Code set forth procedures for current and former officers and employees of the IRS and current and former entities that contract with the IRS to follow when they receive certain requests for disclosure of IRS records or information. It also provides procedures for the public to follow when seeking testimony or IRS records in a nontax proceeding.

Notice 2005-23, page 732.

This notice designates the Indian Ocean tsunamis occurring on December 26, 2004, as a qualified disaster for purposes of section 139 of the Code, and describes the affected areas.

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 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A-9: *The avoided cost method.*

T.D. 9179

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Uniform Capitalization of Interest Expense in Safe Harbor Sale and Leaseback Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains amendments to regulations relating to the capitalization of interest expense incurred in sale and leaseback transactions under the Economic Recovery Tax Act of 1981 (ERTA) safe harbor leasing provisions. The regulations affect taxpayers that provide purchase money obligations in connection with these transactions.

DATES: *Effective Date:* These regulations are effective February 23, 2005.

Applicability Dates: For dates of applicability, see §1.263A-15(a)(3).

FOR FURTHER INFORMATION CONTACT: Christian Wood, 202-622-4930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR Part 1. On May 20, 2004, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG-148399-02, 2004-24 I.R.B. 1066 [69 FR 29113]) by cross reference to temporary regulations (T.D. 9129,

2004-24 I.R.B. 1046 [69 FR 29066]) under section 263A(f) of the Internal Revenue Code (Code). These amendments pertain to the treatment of certain interest expense incurred by the lessor in a sale and leaseback transaction under the ERTA safe harbor leasing provisions (former section 168(f)(8), as enacted by section 201(a) of ERTA, Public Law 97-34, 95 Stat. 214). No comments in response to the proposed regulations or requests to speak at a public hearing were received, and no hearing was held. The proposed regulations under section 263A(f) are adopted by this Treasury decision.

Effective Date

These final regulations generally apply to interest incurred in taxable years beginning on or after May 20, 2004. In the case of property that is inventory in the hands of the taxpayer, these regulations apply to taxable years beginning on or after May 20, 2004. Taxpayers may elect to apply these regulations to interest incurred in taxable years beginning on or after January 1, 1995, or, in the case of property that is inventory in the hands of the taxpayer, to taxable years beginning on or after January 1, 1995 (the general effective date of the interest capitalization regulations).

In addition, for purposes of §1.263A-15(a)(2), the exclusion of purchase money obligations given by the lessor to the lessee (or a party related to the lessee) in a sale and leaseback transaction under former section 168(f)(8) as enacted by ERTA will be considered to be a reasonable position for the application of section 263A(f) in taxable years beginning before January 1, 1995. Consequently, a taxpayer changing a method of accounting for property that is not inventory in the hands of the taxpayer to conform to these regulations may elect to include interest incurred after December 31, 1986, in taxable years beginning on or after December 31, 1986 (the general effective date of section 263A), and before January 1, 1995, in the determination of its adjustment under section 481(a). A taxpayer changing a method of accounting for property that is inventory in the hands of the taxpayer

to conform to these regulations must compute a section 481(a) adjustment and revalue its beginning inventory in the year of change as if the new method of accounting had been in effect during all prior years.

Special Analyses

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

Drafting Information

The principal authors of these regulations are Christian Wood and Grant Anderson of the Office of Associate Chief Counsel (Income Tax & Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 — INCOME TAXES

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

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

Par. 2. In §1.263A-9, paragraph (a)(4)(ix) is added to read as follows:

§1.263A-9 *The avoided cost method.*

(a) * * *

(4) * * *

(ix) A purchase money obligation given by the lessor to the lessee (or a party that is related to the lessee) in a sale and lease-back transaction involving an agreement qualifying as a lease under §5c.168(f)(8)–1 through §5c.168(f)(8)–11 of this chapter. See §5c.168(f)(8)–1(e) *Example (2)* of this chapter.

* * * * *

§1.263A–9T [Removed]

Par. 3. Section 1.263A–9T is removed.

Par. 4. In §1.263A–15, paragraph (a)(3) is added to read as follows:

§1.263A–15 Effective dates, transitional rules, and anti-abuse rule.

(a) * * *

(3) Section 1.263A–9(a)(4)(ix) generally applies to interest incurred in taxable years beginning on or after May 20, 2004. In the case of property that is inventory in the hands of the taxpayer, §1.263A–9(a)(4)(ix) applies to taxable years beginning on or after May 20, 2004. Taxpayers may elect to apply §1.263A–9(a)(4)(ix) to interest incurred in taxable years beginning on or after January 1, 1995, or, in the case of property that is inventory in the hands of the taxpayer, to taxable years beginning on or after January 1, 1995. A change in a taxpayer's treatment of interest to a method consistent with §1.263A–9(a)(4)(ix) is a change in method of accounting to which sections 446 and 481 apply.

* * * * *

§1.263A–15T [Removed]

Par. 5. Section 1.263A–15T is removed.

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

Approved February 15, 2005.

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

(Filed by the Office of the Federal Register on February 22, 2005, 8:45 a.m., and published in the issue of the Federal Register for February 23, 2005, 70 F.R. 8729)

Section 301 (5 USC).— Departmental Regulations

26 CFR 301.9000–1: Definitions when used in sections 301.9000–1 through 301.9000–6.

T.D. 9178

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 301 and 602

Testimony or Production of Records in a Court or Other Proceeding

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations replacing the existing regulation that establishes the procedures to be followed by IRS officers and employees upon receipt of a request or demand for disclosure of IRS records or information. The purpose of the final regulations is to provide specific instructions and to clarify the circumstances under which more specific procedures take precedence. The final regulations extend the application of the regulation to former IRS officers and employees as well as to persons who are or were under contract to the IRS. The final regulations affect current and former IRS officers, employees and contractors, and persons who make requests or demands for disclosure.

DATES: *Effective Date:* These regulations are effective on February 14, 2005.

Applicability Date: For dates of applicability, see §301.9000–7.

FOR FURTHER INFORMATION CONTACT: Scott E. Powers, (202) 622–4580 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been submitted to the **Office of Management and Budget** for review in accordance with the Paperwork Reduction Act of 1995 (44

U.S.C. 3507(d)) under control number 1545–1850.

The collections of information are in §301.9000–5. This information is required to enable the IRS to provide authorizing officials with a better informed basis upon which to determine whether to grant, deny, or limit testimony or the disclosure of IRS records or information so as to conserve agency resources.

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

The burden reflected in the notice of proposed rulemaking (REG–140930–02, 2003–2 C.B. 583) relating to the procedures for IRS officers and employees to follow upon receipt of a request or demand for disclosure of IRS records or information was published in the **Federal Register** (68 FR 40850). Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

Background

This document contains amendments to 26 CFR Part 301 under 5 U.S.C. 301 and 26 CFR Part 602. On July 9, 2003, a notice of proposed rulemaking (REG–140930–02, 2003–2 C.B. 583) relating to the procedures for IRS officers and employees to follow upon receipt of a request or demand for disclosure of IRS records or information was published in the **Federal Register** (68 FR 40850). No comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested or held. The proposed regulations are

adopted as amended by this Treasury decision. With the exception of changes that are grammatical in nature, the revisions are discussed below.

Summary of Comments and Explanation of Revisions

The regulations have been clarified by the addition of an example illustrating a situation in which testimony authorization is required. In addition, text and examples have been added to illustrate that even though testimony authorization may not be required, any disclosure of IRS records and information must be proper under the applicable substantive law. For example, any disclosure of returns and return information must comply with section 6103, and any disclosure of tax convention information must comply with section 6105 and be coordinated with the United States Competent Authority.

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 been determined that 5 U.S.C. 553(b), the Administrative Procedure Act, does not apply to these final regulations.

It is hereby certified that the collection of information in these final regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that of the estimated 1,400 requests received annually, less than 500 of those requests are estimated to be received from small entities. Moreover, the burden associated with complying with the collection of information in these regulations is estimated to be only 1 hour per respondent. 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, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of this final regulation are David Fish and Scott E. Powers, Associate Chief Counsel (Procedure & Administration), Disclosure & Privacy Law Division.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 301 and 602 are amended as follows:

PART 301 PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for Part 301 is amended by adding the following entries in numerical order to read in part as follows:

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

Section 301.9000-1 also issued under 5 U.S.C. 301 and 26 U.S.C. 6103(q) and 7804;

Section 301.9000-2 also issued under 5 U.S.C. 301 and 26 U.S.C. 6103(q) and 7804;

Section 301.9000-3 also issued under 5 U.S.C. 301 and 26 U.S.C. 6103(q) and 7804;

Section 301.9000-4 also issued under 5 U.S.C. 301 and 26 U.S.C. 6103(q) and 7804;

Section 301.9000-5 also issued under 5 U.S.C. 301 and 26 U.S.C. 6103(q) and 7804;

Section 301.9000-6 also issued under 5 U.S.C. 301 and 26 U.S.C. 6103(q) and 7804;

* * *

Par. 2. Section 301.9000-1 is revised and §§301.9000-2 through 301.9000-7 are added to read as follows:

§301.9000-1 Definitions when used in §301.9000-1 through 301.9000-6.

(a) *IRS records or information* means any material (including copies thereof) contained in the files (including paper, electronic or other media files) of the Internal Revenue Service (IRS), any information relating to material contained in the files of the IRS, or any information acquired by an IRS officer or employee, while an IRS officer or employee, as a

part of the performance of official duties or because of that IRS officer's or employee's official status with respect to the administration of the internal revenue laws or any other laws administered by or concerning the IRS. IRS records or information includes, but is not limited to, returns and return information as those terms are defined in section 6103(b)(1) and (2) of the Internal Revenue Code (Code), tax convention information as defined in section 6105 of the Code, information gathered during Bank Secrecy Act and money laundering investigations, and personnel records and other information pertaining to IRS officers and employees. IRS records and information also includes information received, generated or collected by an IRS contractor pursuant to the contractor's contract or agreement with the IRS. The term does not include records or information obtained by IRS officers and employees, solely for the purpose of a federal grand jury investigation, while under the direction and control of the United States Attorney's Office. The term IRS records or information nevertheless does include records or information obtained by the IRS before, during, or after a Federal grand jury investigation if the records or information are obtained—

(1) At the administrative stage of a criminal investigation (prior to the initiation of the grand jury);

(2) From IRS files (such as transcripts or tax returns); or

(3) For use in a subsequent civil investigation.

(b) *IRS officers and employees* means all officers and employees of the United States appointed by, employed by, or subject to the directions, instructions, or orders of the Commissioner or IRS Chief Counsel and also includes former officers and employees.

(c) *IRS contractor* means any person, including the person's current and former employees, maintaining IRS records or information pursuant to a contract or agreement with the IRS, and also includes former contractors.

(d) A *request* is any request for testimony of an IRS officer, employee or contractor or for production of IRS records or information, oral or written, by any person, which is not a demand.

(e) A *demand* is any subpoena or other order of any court, administrative agency

or other authority, or the Congress, or a committee or subcommittee of the Congress, and any notice of deposition (either upon oral examination or written questions), request for admissions, request for production of documents or things, written interrogatories to parties, or other notice of, request for, or service for discovery in a matter before any court, administrative agency or other authority.

(f) An *IRS matter* is any matter before any court, administrative agency or other authority in which the United States, the Commissioner, the IRS, or any IRS officer or employee acting in an official capacity, or any IRS officer or employee (including an officer or employee of IRS Office of Chief Counsel) in his or her individual capacity if the United States Department of Justice or the IRS has agreed to represent or provide representation to the IRS officer or employee, is a party and that is directly related to official business of the IRS or to any law administered by or concerning the IRS, including, but not limited to, judicial and administrative proceedings described in section 6103(h)(4) and (l)(4) of the Internal Revenue Code.

(g) An *IRS congressional matter* is any matter before the Congress, or a committee or subcommittee of the Congress, that is related to the administration of the internal revenue laws or any other laws administered by or concerning the IRS, or to IRS records or information.

(h) A *non-IRS matter* is any matter that is not an IRS matter or an IRS congressional matter.

(i) A *testimony authorization* is a written instruction or oral instruction memorialized in writing within a reasonable period by an authorizing official that sets forth the scope of and limitations on proposed testimony and/or disclosure of IRS records or information issued in response to a request or demand for IRS records or information. A testimony authorization may grant or deny authorization to testify or disclose IRS records or information and may make an authorization effective only upon the occurrence of a precedent condition, such as the receipt of a consent complying with the provisions of section 6103(c) of the Code. To authorize testimony means to issue the instruction described in this paragraph (i).

(j) An *authorizing official* is a person with delegated authority to authorize tes-

timony and the disclosure of IRS records or information.

§301.9000-2 Considerations in responding to a request or demand for IRS records or information.

(a) *Situations in which disclosure shall not be authorized.* Authorizing officials shall not permit testimony or disclosure of IRS records or information in response to requests or demands if testimony or disclosure of IRS records or information would—

(1) Violate a Federal statute including, but not limited to, sections 6103 or 6105 of the Internal Revenue Code (Code), the Privacy Act of 1974 (5 U.S.C. 552a), or a rule of procedure, such as the grand jury secrecy rule, Fed. R. Crim. P. 6(e);

(2) Violate a specific Federal regulation, including, but not limited to, 31 CFR 103.53;

(3) Reveal classified national security information, unless properly declassified;

(4) Reveal the identity of an informant; or

(5) Reveal investigatory records or information compiled for law enforcement purposes that would permit interference with law enforcement proceedings or would disclose investigative techniques and procedures, the effectiveness of which could thereby be impaired.

(b) *Assertion of privileges.* Any applicable privilege or protection under law may be asserted in response to a request or demand for testimony or disclosure of IRS records or information, including, but not limited to, the following—

(1) Attorney-client privilege;

(2) Attorney work product doctrine; and

(3) Deliberative process (executive) privilege.

(c) *Non-IRS matters.* If any person makes a request or demand for IRS records or information in connection with a non-IRS matter, authorizing officials shall take into account the following additional factors in responding to the request or demand—

(1) Whether the requester is a Federal agency, or a state or local government or agency thereof;

(2) Whether the demand was issued by a Federal or state court, administrative agency or other authority;

(3) The potential effect of the case on the administration of the internal revenue laws or any other laws administered by or concerning the IRS;

(4) The importance of the legal issues presented;

(5) Whether the IRS records or information are available from other sources;

(6) The IRS's anticipated commitment of time and anticipated expenditure of funds necessary to comply with the request or demand;

(7) The number of similar requests and their cumulative effect on the expenditure of IRS resources;

(8) Whether the request or demand allows a reasonable time for compliance (generally, at least fifteen business days);

(9) Whether the testimony or disclosure is appropriate under the rules of procedure governing the case or matter in which the request or demand arises;

(10) Whether the request or demand involves expert witness testimony;

(11) Whether the request or demand is for the testimony of an IRS officer, employee or contractor who is without personal knowledge of relevant facts;

(12) Whether the request or demand is for the testimony of a presidential appointee or senior executive and whether the testimony of a lower-level official would suffice;

(13) Whether the procedures in §301.9000-5 have been followed; and

(14) Any other relevant factors that may be brought to the attention of the authorizing official.

§301.9000-3 Testimony authorizations.

(a) *Prohibition on disclosure of IRS records or information without testimony authorization.* Except as provided in paragraph (b) of this section, when a request or demand for IRS records or information is made, no IRS officer, employee or contractor shall testify or disclose IRS records or information to any court, administrative agency or other authority, or to the Congress, or to a committee or subcommittee of the Congress without a testimony authorization. However, an IRS officer, employee or contractor may appear in person to advise that he or she is awaiting instructions from an authorizing official with respect to the request or demand.

(b) *Exceptions.* No testimony authorization is required in the following circumstances—

(1) To respond to a request or demand for IRS records or information by the attorney or other government representative representing the IRS in a particular IRS matter;

(2) To respond solely in writing, under the direction of the attorney or other government representative, to requests and demands in IRS matters, including, but not limited to, admissions, document production, and written interrogatories to parties;

(3) To respond to a request or demand issued to a former IRS officer, employee or contractor for expert or opinion testimony if the testimony sought from the former IRS officer, employee or contractor involves general knowledge (such as information contained in published procedures of the IRS or the IRS Office of Chief Counsel) gained while the former IRS officer, employee or contractor was employed or under contract with the IRS; or

(4) If a more specific procedure established by the Commissioner governs the disclosure of IRS records or information. These procedures include, but are not limited to, those relating to: procedures pursuant to §601.702(d) of this chapter; Freedom of Information Act requests pursuant to 5 U.S.C. 552; Privacy Act of 1974 requests pursuant to 5 U.S.C. 552a; disclosures to state tax agencies pursuant to section 6103(d) of the Internal Revenue Code (Code); and disclosures to the United States Department of Justice pursuant to an *ex parte* order under section 6103(i)(1) of the Code.

(c) *Disclosures of IRS records or information with or without testimony authorization must be permitted under other applicable law.* Any disclosure of IRS records or information that is otherwise permissible under this section must not be prohibited under applicable law. For example, in a case in which returns and return information may be disclosed, the disclosure must be authorized under section 6103, even if any required testimony authorization is obtained. If tax convention information (as defined under section 6105) may be disclosed, in deciding whether the disclosure is authorized, the authorizing official must coordinate the disclosure with the U.S. Competent Authority.

§301.9000-4 *Procedure in the event of a request or demand for IRS records or information.*

(a) *Purpose and scope.* This section prescribes procedures to be followed by IRS officers, employees and contractors upon receipt of a request or demand in matters in which a testimony authorization is or may be required.

(b) *Notification of the Disclosure Officer.* Except as provided in paragraphs (c), (d), and (e) of this section, an IRS officer, employee or contractor who receives a request or demand for IRS records or information for which a testimony authorization is or may be required shall notify promptly the disclosure officer servicing the IRS officer's, employee's or contractor's geographic area. The IRS officer, employee or contractor shall await instructions from the authorizing official concerning the response to the request or demand. An IRS officer, employee, or contractor who receives a request or demand in one of the following matters should not notify the disclosure officer, but should follow the instructions in paragraph (c), (d), or (e) of this section, as applicable:

(1) United States Tax Court cases.

(2) Personnel matters, labor relations matters, government contract matters, matters related to informant claims or matters related to the rules of *Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics*, 403 U.S. 388 (1971) (*Bivens* matters), or matters under the Federal Tort Claims Act (FTCA).

(3) IRS congressional matters.

(c) *Requests or demands in United States Tax Court cases.* An IRS officer, employee or contractor who receives a request or demand for IRS records or information on behalf of a petitioner in a United States Tax Court case shall notify promptly the IRS Office of Chief Counsel attorney assigned to the case. The IRS Office of Chief Counsel attorney shall notify promptly the authorizing official. The IRS officer, employee or contractor who received the request or demand shall await instructions from the authorizing official.

(d) *Requests or demands in personnel, labor relations, government contract, Bivens or FTCA matters, or matters related to informant claims.* An IRS officer, employee or contractor who receives a request or demand, on behalf of an appellant,

grievant, complainant or representative, for IRS records or information in a personnel, labor relations, government contract, Bivens or FTCA matter, or matter related to informant claims, shall notify promptly the IRS Associate Chief Counsel (General Legal Services) attorney assigned to the case. If no IRS Associate Chief Counsel (General Legal Services) attorney is assigned to the case, the IRS officer, employee or contractor shall notify promptly the IRS Associate Chief Counsel (General Legal Services) attorney servicing the geographic area. The IRS Associate Chief Counsel (General Legal Services) attorney shall notify promptly the authorizing official. The IRS officer, employee or contractor who received the request or demand shall await instructions from the authorizing official.

(e) *Requests or demands in IRS congressional matters.* An IRS officer, employee or contractor who receives a request or demand in an IRS congressional matter shall notify promptly the IRS Office of Legislative Affairs. The IRS officer, employee or contractor who received the request or demand shall await instructions from the authorizing official.

(f) *Opposition to a demand for IRS records or information in IRS and non-IRS matters.* If, in response to a demand for IRS records or information, an authorizing official has not had a sufficient opportunity to issue a testimony authorization, or determines that the demand for IRS records or information should be denied, the authorizing official shall request the government attorney or other representative of the government to oppose the demand and respectfully inform the court, administrative agency or other authority, by appropriate action, that the authorizing official either has not yet issued a testimony authorization, or has issued a testimony authorization to the IRS officer, employee or contractor that denies permission to testify or disclose the IRS records or information. If the authorizing official denies authorization in whole or in part, the government attorney or other representative of the government shall inform the court, administrative agency or other authority of the reasons the authorizing official gives for not authorizing the testimony or the disclosure of the IRS records or information or take other action in opposition as may be appropriate (including,

but not limited to, filing a motion to quash or a motion to remove to Federal court).

(g) *Procedure in the event of an adverse ruling.* In the event the court, administrative agency, or other authority rules adversely with respect to the refusal to disclose the IRS records or information pursuant to the testimony authorization, or declines to defer a ruling until a testimony authorization has been received, the IRS officer, employee or contractor who has received the request or demand shall, pursuant to this section, respectfully decline to testify or disclose the IRS records or information.

(h) *Penalties.* Any IRS officer or employee who discloses IRS records or information without following the provisions of this section or §301.9000–3, may be subject to administrative discipline, up to and including dismissal. Any IRS officer, employee or contractor may be subject to applicable contractual sanctions and civil or criminal penalties, including prosecution under 5 U.S.C. 552a(i), for willful disclosure in an unauthorized manner of information protected by the Privacy Act of 1974, or under section 7213 of the Internal Revenue Code, for willful disclosure in an unauthorized manner of return information.

(i) *No creation of benefit or separate privilege.* Nothing in §§301.9000–1 through 301.9000–3, this section, and §§301.9000–5 and 301.9000–6, creates, is intended to create, or may be relied upon to create, any right or benefit, substantive or procedural, enforceable at law by a party against the United States. Nothing in these regulations creates a separate privilege or basis to withhold IRS records or information.

§301.9000–5 Written statement required for requests or demands in non-IRS matters.

(a) *Written statement.* A request or demand for IRS records or information for use in a non-IRS matter shall be accompanied by a written statement made by or on behalf of the party seeking the testimony or disclosure of IRS records or information, setting forth—

(1) A brief description of the parties to and subject matter of the proceeding and the issues;

(2) A summary of the testimony, IRS records or information sought, the relevance to the proceeding, and the estimated volume of IRS records involved;

(3) The time that will be required to present the testimony (on both direct and cross examination);

(4) Whether any of the IRS records or information is a return or is return information (as defined in section 6103(b) of the Internal Revenue Code (Code)), or tax convention information (as defined in section 6105(c)(1) of the Code), and the statutory authority for the disclosure of the return or return information (and, if no consent to disclose pursuant to section 6103(c) of the Code accompanies the request or demand, the reason consent is not necessary);

(5) Whether a declaration of an IRS officer, employee or contractor under penalties of perjury pursuant to 28 U.S.C. 1746 would suffice in lieu of deposition or trial testimony;

(6) Whether deposition or trial testimony is necessary in a situation in which IRS records may be authenticated without testimony under applicable rules of evidence and procedure;

(7) Whether IRS records or information are available from other sources; and

(8) A statement that the request or demand allows a reasonable time (generally at least fifteen business days) for compliance.

(b) *Permissible waiver of statement.* The requirement of a written statement in paragraph (a) of this section may be waived by the authorizing official for good cause.

§301.9000–6 Examples.

The following examples illustrate the provisions of §§301.9000–1 through 301.9000–5:

Example 1. A taxpayer sues a practitioner in state court for malpractice in connection with the practitioner's preparation of a Federal income tax return. The taxpayer subpoenas an IRS employee to testify concerning the IRS employee's examination of the taxpayer's Federal income tax return. The taxpayer provides the statement required by §301.9000–5. This is a non-IRS matter. A testimony authorization would be required for the IRS employee to testify. (In addition, the taxpayer would be required to execute an appropriate consent under section 6103(c) of the Code). The IRS would oppose the IRS employee's appearance in this case because the IRS is a disinterested party with respect to the dispute and would consider the commitment of resources to comply with the subpoena inappropriate.

Example 2. In a state judicial proceeding concerning child support, the child's custodial parent subpoenas for a deposition an IRS agent who is examining certain post-divorce Federal income tax returns of the non-custodial parent. This is a non-IRS matter. The custodial parent submits with the subpoena the statement required by §301.9000–5 stating as the reason for the lack of taxpayer consent to disclosure that the non-custodial parent has refused to provide the consent (both a consent from the taxpayer complying with section 6103(c) and a testimony authorization would be required prior to the IRS agent testifying at the deposition). If taxpayer consent is obtained, the IRS may provide a declaration or certified return information of the taxpayer. A deposition would be unnecessary under the circumstances.

Example 3. The chairperson of a congressional committee requests the appearance of an IRS employee before the committee and committee staff to submit to questioning by committee staff concerning the procedures for processing Federal employment tax returns. This is an IRS congressional matter. Even though questioning would not involve the disclosure of returns or return information, the questioning would involve the disclosure of IRS records or information; therefore, a testimony authorization would be required. The IRS employee must contact the IRS Office of Legislative Affairs for instructions before appearing.

Example 4. The IRS opens a criminal investigation as to the tax liabilities of a taxpayer. This is an IRS matter. During the criminal investigation, the IRS refers the matter to the United States Department of Justice, requesting the institution of a Federal grand jury to investigate further potential criminal tax violations. The United States Department of Justice approves the request and initiates a grand jury investigation. The grand jury indicts the taxpayer. During the taxpayer's trial, the taxpayer subpoenas an IRS special agent for testimony regarding the investigation. The records and information collected during the administrative stage of the investigation, including the taxpayer's tax returns from IRS files, are IRS records and information. A testimony authorization is required for the IRS special agent to testify regarding this information. However, no IRS testimony authorization is required regarding the information collected by the IRS special agent when the IRS special agent was acting under the direction and control of the United States Attorney's Office in the Federal grand jury investigation. That information is not IRS records or information within the meaning of §301.9000–1(a). Disclosure of that information should be coordinated with the United States Attorney's Office.

Example 5. The United States Department of Justice attorney representing the IRS in a suit for refund requests testimony from an IRS revenue agent. This is an IRS matter. A testimony authorization would not be required for the IRS revenue agent to testify because the testimony was requested by the government attorney.

Example 6. In response to a request by the taxpayer's counsel to interview an IRS revenue agent who was involved in a case at the administrative level, the United States Department of Justice attorney representing the IRS in a suit for refund asks that the IRS revenue agent be made available to be interviewed. This is an IRS matter. A testimony authorization

would be required for the IRS revenue agent to testify because the testimony was first requested by taxpayer's counsel.

Example 7. A state assistant attorney general, acting in accordance with a recommendation from his state's department of revenue, is prosecuting a taxpayer under a state criminal law proscribing the intentional failure to file a state income tax return. The assistant attorney general serves an IRS employee with a subpoena to testify concerning the taxpayer's Federal income tax return filing history. This is a non-IRS matter. This is also a state judicial proceeding pertaining to tax administration within the meaning of section 6103(h)(4) and (b)(4). As such, the requirements of section 6103(h)(4) apply. A testimony authorization would be required for the testimony demand in the subpoena.

Example 8. A former IRS revenue agent is requested to testify in a divorce proceeding. The request seeks testimony explaining the meaning of entries appearing on one party's transcript of account, which is already in the possession of the parties. This is a non-IRS matter. No testimony authorization is required because the testimony requested from the former IRS employee involves general knowledge gained while the former IRS revenue agent was employed with the IRS.

Example 9. A Department of Justice attorney requests an IRS employee to testify in a refund suit involving Taxpayer A. The testimony may include tax convention information, as defined in section 6105, which was originally obtained by the IRS from a treaty partner in connection with a tax case against Taxpayer B. While no testimony authorization is necessary, because the testimony is being requested by government counsel in a tax matter, the IRS employee may not testify (or otherwise disclose IRS records or information) without coordinating with the U.S. Competent Authority, as disclosure of tax convention information is governed by section 6105. The disclosure must also meet the requirements in section 6103(h)(4).

Example 10. In a state court tort action, Defendant subpoenas IRS for Plaintiff's federal income tax returns for particular taxable years. This is a non-IRS matter. The Disclosure Officer instructs Defendant that the IRS has established procedures for obtaining copies of Federal income tax returns. Section 601.702(d)(1) of this chapter establishes the procedures for obtaining Federal tax returns by requiring written requests for copies of tax returns using IRS Form 4506, "Request for Copy of Tax Return." At Defendant's request, Plaintiff executes Form 4506, naming Defendant's counsel as designee, and the form is properly submitted to IRS. A testimony authorization

would not be required to disclose Plaintiff's returns to Defendant's counsel.

§301.9000-7 Effective date.

These regulations are applicable on February 14, 2005.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry for §301.9000-5 in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
301.9000-5	1545-1850
* * * * *	

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

Approved February 3, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 11, 2005, 8:45 a.m., and published in the issue of the Federal Register for February 14, 2005, 70 F.R. 7396)

Section 368.— Definitions Relating to Corporate Reorganizations

26 CFR 1.368-1: Purpose and scope of exception of reorganization exchanges.

T.D. 9182

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Reorganizations Under Section 368(a)(1)(E) and Section 368(a)(1)(F)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations regarding reorganizations under section 368(a)(1)(E) and sec-

tion 368(a)(1)(F) of the Internal Revenue Code. The regulations affect corporations and their shareholders.

DATES: Effective Date: These regulations are effective on February 25, 2005.

Applicability Date: These regulations apply to transactions occurring on or after February 25, 2005.

FOR FURTHER INFORMATION CONTACT: Robert B. Gray, at (202) 622-7550 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On August 12, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG-106889-04, 2004-38 I.R.B. 501) in the **Federal Register** (69 FR 49836) proposing regulations regarding the requirements for a reorganization under section 368(a)(1)(E)

and section 368(a)(1)(F) of the Internal Revenue Code (Code). Generally, a transaction must satisfy the continuity of interest and continuity of business enterprise requirements to qualify as a reorganization under section 368(a). The notice proposed amending §1.368-1(b) to provide that a continuity of interest and a continuity of business enterprise are not required for a transaction to qualify as a reorganization under section 368(a)(1)(E) (E reorganization) or section 368(a)(1)(F) (F reorganization). The notice also proposed amending §1.368-2 to include rules regarding the requirements for a transaction to qualify as an F reorganization and regarding the effects of an F reorganization.

The IRS and Treasury Department have received oral comments urging that the rule providing that the continuity of interest and continuity of business enterprise requirements do not apply to E and F reorganizations be finalized quickly. For the reasons expressed in the preamble to the proposed regulations, this Treasury decision adopts that rule for transactions on or after February 25, 2005. The IRS and Treasury Department continue to study the other issues addressed in the notice of proposed rulemaking, and welcomes further comment on those issues.

Effect on Other Documents

The following publications are obsolete as of February 25, 2005:

- Rev. Rul. 69-516, 1969-2 C.B. 56.
- Rev. Rul. 77-415, 1977-2 C.B. 311.
- Rev. Rul. 77-479, 1977-2 C.B. 119.
- Rev. Rul. 82-34, 1982-1 C.B. 59.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were

submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

* * * * *

Adoption of Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 — INCOME TAXES

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

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

Par. 2. Section 1.368-1(b) is amended by adding a sentence after the seventh sentence to read as follows:

§1.368-1 Purpose and scope of exception of reorganization exchanges.

* * * * *

(b) *Purpose.* * * * Notwithstanding the requirements of this paragraph (b), for transactions occurring on or after February 25, 2005, a continuity of the business enterprise and a continuity of interest are not required for the transaction to qualify as a reorganization under section 368(a)(1)(E) or (F). * * *

* * * * *

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

Approved February 14, 2005.

Eric Solomon,
*Acting Deputy Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on February 24, 2005, 8:45 a.m., and published in the issue of the Federal Register for February 25, 2005, 70 F.R. 9219)

Section 1374.—Tax Imposed on Certain Built-In Gains

26 CFR 1.1374-3: Net unrealized built-in gain.

T.D. 9180

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Adjustment to Net Unrealized Built-in Gain

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

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

DATES: *Effective Date:* These regulations are effective February 23, 2005.

Applicability Dates: For dates of applicability, see §1.1374-10.

FOR FURTHER INFORMATION CONTACT: Jennifer D. Sledge, (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains amendments to Income Tax Regulations (26 CFR part 1) under section 1374 of the Internal Revenue Code, relating to the tax imposed on certain recognized built-in gains of S corporations. Section 1374 imposes a tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation for the 10-year period beginning on the first day the corporation is an S corporation and assets that it acquired

from a C corporation in a carryover basis transaction for the 10-year period beginning on the day of the acquisition. A separate determination of the amount subject to tax under section 1374 is required for those assets the S corporation held on the date it converted to C status and each pool of assets the S corporation acquired in a carryover basis transaction from a C corporation. The total amount subject to tax under section 1374 for each pool of assets is limited to that pool's net unrealized built-in gain (NUBIG) on the date of the conversion or acquisition.

Under the current rules, if X, a C corporation, elects to be an S corporation when it owns some or all of the stock of Y, a C corporation, and Y subsequently transfers its assets to X in a liquidation to which sections 332 and 337(a) apply or in a reorganization described in section 368(a), the built-in gain or built-in loss in Y's assets may be wholly or partially reflected twice: once in the NUBIG attributable to the assets X owned on the date of its conversion (including the Y stock) and a second time in the NUBIG attributable to Y's former assets acquired by X in the liquidation of Y. The IRS and Treasury Department recognize that continuing to reflect the built-in gain or the built-in loss in the Y stock at the time of X's conversion after the liquidation or reorganization is inconsistent with the fact that such liquidation or reorganization has the effect of eliminating that built-in gain or built-in loss. Therefore, on June 25, 2004, the IRS and Treasury Department published in the **Federal Register** (69 FR 35544) a notice of proposed rulemaking (REG-131486-03, 2004-28 I.R.B. 36) that includes regulations proposing an adjustment to the NUBIG in these cases. In particular, the proposed regulations generally provide that, if an S corporation acquires assets of a C corporation in a carryover basis transaction, some or all of the stock of the C corporation from which such assets were acquired was taken into account in the computation of NUBIG for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to certain limitations, such NUBIG is adjusted to eliminate any effect any built-in gain or built-in loss in the redeemed or canceled stock had on the initial computation of NUBIG for that pool of assets.

These regulations are proposed to apply for taxable years beginning after the date they are published as final regulations in the **Federal Register**.

No public hearing was requested or held regarding the proposed regulations. One written comment, however, was received. That comment requested that the proposed regulations be made effective as soon as possible.

These final regulations adopt the proposed regulations without substantive change as final regulations. However, the final regulations do modify the proposed effective date of the regulations. The final regulations apply to section 1374(d)(8) transactions that occur in taxable years beginning after February 23, 2005. The final regulations also provide that an S corporation may apply the regulations to section 1374(d)(8) transactions that occur in taxable years beginning on or before February 23, 2005, if the S corporation (and any predecessors or successors) and all affected shareholders file original or amended returns that are consistent with the regulations for taxable years of the S corporation during the recognition period of the pool of assets the NUBIG of which would be adjusted pursuant to the regulations that are not closed as of the first date after February 23, 2005 that the S corporation files an original or amended return.

Special Analyses

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

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1 — INCOME TAXES

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

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

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

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

The revision and addition read as follows:

§1.1374-3 Net unrealized built-in gain.

* * * * *

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

(2) *Limitations on adjustment* — (i) *Recognized built-in gain or loss*. Net unrealized built-in gain for a pool of assets of the S corporation is only adjusted

under paragraph (b)(1) of this section to reflect built-in gain or built-in loss in the redeemed or canceled stock that has not resulted in recognized built-in gain or recognized built-in loss during the recognition period.

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

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

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

(i) The assets held by the corporation on the first day it became an S corporation, if

the corporation was previously a C corporation; or

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

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

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

Assets	FMV	Basis
Factory	\$500,000	\$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000
Liabilities	Amount	
Mortgage	\$200,000	
Accounts Payable	100,000	
Total	300,000	

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

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be \$1,050,000 (\$750,000

cash received + \$300,000 liabilities assumed = \$1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

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

Example 2. Adjustment to net unrealized built-in gain for built-in gain in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of \$15,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of \$33,000 and an adjusted basis of \$18,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, and as a result has \$10,000 of recognized built-in gain. X has had no other recognized built-in gain or built-in loss. X's taxable income limitation for 2009 is \$50,000. Effective June 1, 2009, X elects under section 1361 to treat Y as a qualified subchapter S subsidiary (QSub). The election is treated as a transfer of Y's assets to X in a liquidation to which sections 332 and 337(a) apply.

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

1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is \$0.

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

Example 3. Adjustment to net unrealized built-in gain for built-in loss in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of negative \$5,000. Among the assets in the first pool of assets is 10 percent of the outstanding stock of Y, a C corporation, with a fair market value of \$18,000 and an adjusted basis of \$33,000. On March 1, 2009, X sells an asset

that it owned on January 1, 2005, resulting in \$8,000 of recognized built-in gain. X has had no other recognized built-in gains or built-in losses. X's taxable income limitation for 2009 is \$50,000. On June 1, 2009, Y transfers its assets to X in a reorganization under section 368(a)(1)(C).

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

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

recognized built-in gain for the taxable year ending on December 31, 2009. X's net unrealized built-in gain limitation for 2010 is \$2,000.

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

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

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

§1.1374-10 Effective date and additional rules.

(a) *In general.* Sections 1.1374-1 through 1.1374-9, other than §1.1374-3(b) and (c) *Examples 2 through 4*, apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994. Section 1.1374-3(b) and (c) *Examples 2 through 4* apply to section 1374(d)(8) transactions that occur in taxable years beginning after February 23, 2005. In addition, an S corporation may apply §1.1374-3(b) and (c) *Examples 2 through 4* to section 1374(d)(8) transactions that occur in taxable years beginning on or before February 23, 2005, if the S corporation (and any predecessors or

successors) and all affected shareholders file original or amended returns that are consistent with these provisions for taxable years of the S corporation during the recognition period of the pool of assets the net unrealized built-in gain of which would be adjusted pursuant to those provisions that are not closed as of the first date after February 23, 2005, that the S corporation files an original or amended return. For purposes of this section, affected shareholders means all shareholders who received distributive shares of S corporation items in such taxable years. However, the Commissioner may, in appropriate circumstances, permit taxpayers to apply these provisions even if all affected shareholders cannot file consistent returns. In addition, for this purpose, a predecessor of an S corporation is a corporation that transfers its assets to the S corporation in a transaction to which section 381 applies. A successor of an S corporation is a corporation to which the S corporation transfers its assets in a transaction to which section 381 applies.

* * * * *

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

Approved February 14, 2005.

Eric Solomon,
*Acting Deputy Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on February 22, 2005, 8:45 a.m., and published in the issue of the Federal Register for February 23, 2005, 70 F.R. 8727)

Section 2702.—Special Valuation Rules in Case of Transfers of Interests in Trusts

26 CFR 25.2702-2: Definitions and valuation rules.

T.D. 9181

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 25

Qualified Interests

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations amending the regulations under the gift tax special valuation rules to provide that a unitrust or annuity interest payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to the expiration of the term, is a qualified interest for the specified term. The final regulations also clarify that the exception treating a spouse's revocable successor interest as a retained qualified interest applies only if the spouse's annuity or unitrust interest, standing alone, would constitute a qualified interest that meets the requirements of §25.2702-3(d)(3), but for the grantor's revocation power.

DATES: The regulations are effective July 26, 2004.

FOR FURTHER INFORMATION CONTACT: Juli Ro Kim (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On July 26, 2004, the IRS published in the **Federal Register** (69 FR 44476) a notice of proposed rulemaking (REG-163679-02, 2004-35 I.R.B. 390) conforming the gift tax regulations defining a qualified interest for purposes of section 2702 to the Tax Court's decision in *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq. in result*, Notice 2003-72, 2003-2 C.B. 964. In *Walton*, the court declared *Example 5* of §25.2702-3(e) to

be invalid. The notice of proposed rule-making also clarifies those parts of the regulations under section 2702 addressing revocable spousal interests that were at issue in *Schott v. Commissioner*, 319 F.3d 1203 (9th Cir. 2003), *rev'g and remanding* T.C.M. 2001-110, and *Cook v. Commissioner*, 269 F.3d 854 (7th Cir. 2001), *aff'g* 115 T.C. 15 (2000).

No public hearing was requested or held, but one written comment and some telephone comments were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding proposed regulations are removed. The comments and revisions to the proposed regulations are discussed below.

Summary of Comments

Generally, the commentators agreed with the amendments conforming the regulations to the *Walton* decision. Several commentators requested that the regulations address the amount includible in the grantor's gross estate with respect to a *Walton*-type grantor retained annuity trust (GRAT), if the grantor dies during the GRAT term, including the application of Rev. Rul. 82-105, 1982-1 C.B. 133. In addition, several commentators requested guidance regarding the application of section 2035 if the grantor dies within three years after termination of the term of the GRAT (or grantor retained unitrust (GRUT)). These suggestions were not adopted. The determination of the amount includible in the grantor's gross estate is an issue different from and governed by different Code sections than the definition of a qualified interest for purposes of section 2702, and is thus beyond the scope of this project. However, Treasury and IRS will consider addressing that issue in future guidance.

Regarding the proposed regulations addressing revocable spousal interests, commentators suggested that section 2702 was enacted to avoid valuation problems and that, because the value of the contingent revocable spousal interest at issue in *Schott v. Commissioner* is readily determinable using actuarial tables, such an interest should be a qualified interest (as the Ninth Circuit concluded in *Schott*).

Treasury and the IRS continue to believe that the proposed regulations properly implement section 2702 and the policy underlying the statute. Uncertainty in valuation is not the only valuation inaccuracy that the statute was intended to correct. A valuation inaccuracy is also present when the value of a retained interest is increased through the use of a joint and survivor (or two-life) annuity or unitrust interest if there is no certainty that the survivorship interest will ever be paid. The revocable spousal interest involved in *Schott* may best be described as speculative, because it takes effect, if at all, only if the grantor fails to survive the term of the trust, and the duration of the interest, if it takes effect at all, is dependent on the portion of the term remaining at the grantor's death. The existing regulations make it clear that the ability to actuarially determine an interest is not sufficient to secure recognition of that interest as a qualified interest for purposes of section 2702. Under *Example 1* of §25.2702-2(d)(1), neither a retained income interest for life nor a contingent reversionary interest in trust corpus payable to the grantor's estate if the grantor dies prior to the expiration of the trust term is a qualified interest, notwithstanding that the present value of both the income interest and the contingent reversion is readily determinable actuarially. Just as the contingent reversion in *Example 1* would increase the value of the retained interest without any certainty that the reversion would ever be paid, a revocable spousal interest of the kind at issue in *Schott* would similarly increase the value of the retained interest without any certainty that the spouse's survivorship interest would ever be paid.

Some commentators requested that the regulations also confirm the gift tax consequences of the lapse of the grantor's retained right to revoke the spouse's successor interest, for example when that revocation right lapses at the end of the GRAT term and the spouse's successor interest becomes operative. In response, language has been added to §25.2702-3(e), *Example 8*, to clarify that the grantor makes a completed gift to the spouse when the revocation right lapses on the expiration of the grantor's retained term (the grantor having survived the term and not having exercised the revocation right). See §25.2511-2(f).

Other commentators suggested that the regulations also address the treatment of a revocable spousal interest in a *Walton*-type GRAT when the grantor's spouse is given a revocable survivor interest in the annuity payments to be made during the balance of the fixed term of the GRAT remaining after the grantor's death. Specifically, if the grantor dies prior to the expiration of the fixed GRAT term, the annuity interest is payable to the spouse for the balance of that term, subject to the grantor's power to revoke the spousal interest or, if the spousal interest is revoked, then to the grantor's estate for the balance of the fixed term. The commentators suggested that regardless of whether the grantor dies during the stated term or survives, the annuity or unitrust interest will be paid for a fixed term of years either to the grantor, the surviving spouse, or the grantor's estate. Accordingly, the commentators suggested that the interest is payable in all events for a fixed term, and is therefore a qualified interest. The commentators' suggestion would extend the concept espoused by the Tax Court in *Walton* of an "undifferentiated unit" consisting of the grantor and the grantor's estate (see 115 T.C. at 603) to include the grantor, the grantor's estate, and the grantor's spouse. Treasury and the IRS do not believe that the Tax Court opinion supports this extension. The spouse's revocable successor interest is an interest separate and distinct from the interest of the grantor and the grantor's estate. Further, the use of the spouse's life expectancy in valuing the retained interest would increase the value of that interest without any guarantee that the spouse would actually receive any part of that interest. For these reasons, the spouse's revocable successor interest described above does not satisfy the requirements of a qualified interest. Accordingly, this suggestion was not adopted.

Special Analyses

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

on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the Notice of Proposed Rulemaking preceding these regulations was submitted to the Small Business Administration for comment on their impact on small business.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 25 is amended as follows:

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Paragraph 1. The authority citation for part 25 continues to read, in part, as follows:

Authority: 25 U.S.C. 7805 * * *

Par. 2. In §25.2702-0, the table is amended as follows:

1. The entries for §25.2702-2(a)(5) through §25.2702-2(a)(9) are redesignated as §25.2702-2(a)(6) through §25.2702-2(a)(10), respectively.

2. A new entry for §25.2702-2(a)(5) is added.

3. The entries for §25.2702-3(d)(2) through §25.2702-3(d)(4) are redesignated as §25.2702-3(d)(3) through §25.2702-3(d)(5), respectively.

4. A new entry for §25.2702-3(d)(2) is added.

5. An entry for §25.2702-3(d)(6) is added.

The additions read as follows:

§25.2702-0 Table of contents.

* * * * *

§25.2702-2 Definitions and valuation rules.

(a) * * *

(5) Holder.

* * * * *

§25.2702-3 Qualified interests.

* * * * *

(d) * * *

(2) Contingencies.

* * * * *

(6) Use of debt obligations to satisfy the annuity or unitrust payment obligation.

* * * * *

Par. 3. Section 25.2702-2 is amended as follows:

1. Paragraphs (a)(5) through (a)(9) are redesignated as paragraphs (a)(6) through (a)(10), respectively.

2. A new paragraph (a)(5) is added.

3. In newly designated paragraph (a)(6), the second sentence is removed and two sentences are added in its place.

4. In paragraph (d)(1), *Example 6* and *Example 7* are removed.

5. In paragraph (d)(2), introductory text, the language “*Examples 8–10*” is revised to read “*Examples 6 through 8*”.

6. In paragraph (d)(2), *Examples 8, 9* and *10* are redesignated *Examples 6, 7* and *8*, respectively.

The additions read as follows:

§25.2702-2 Definitions and valuation rules.

(a) * * *

(5) *Holder*. The holder is the person to whom the annuity or unitrust interest is payable during the fixed term of that interest. References to holder shall also include the estate of that person.

(6) * * * If a transferor retains a power to revoke a qualified annuity interest or qualified unitrust interest of the transferor’s spouse, then the revocable qualified annuity or unitrust interest of the transferor’s spouse is treated as a retained qualified interest of the transferor. In order for the transferor to be treated as having retained a qualified interest under the preceding sentence, the interest of the transferor’s spouse (the successor holder) must be an interest that meets the requirements of a qualified annuity interest in accordance with §25.2702-3(b) and (d), or a qualified unitrust interest in accordance with §25.2702-3(c) and (d), but for

the transferor’s retained power to revoke the interest. * * *

* * * * *

Par. 4. Section 25.2702-3 is amended as follows:

1. Paragraphs (d)(2) through (d)(5) are redesignated as paragraphs (d)(3) through (d)(6), respectively.

2. A new paragraph (d)(2) is added.

3. In newly designated paragraph (d)(4), the first two sentences are revised.

4. Newly designated paragraph (d)(5) is revised.

5. In paragraph (e), *Example 5*, the last sentence is revised.

6. In paragraph (e), *Example 6*, the last sentence is removed and two new sentences are added in its place.

7. In paragraph (e), new *Example 8* and new *Example 9* are added.

The revisions and additions read as follows:

§25.2702-3 Qualified interests.

* * * * *

(d) * * *

(2) *Contingencies*. A holder’s qualified interest must be payable in any event to or for the benefit of the holder for the fixed term of that interest. Thus, payment of the interest cannot be subject to any contingency other than either the survival of the holder until the commencement, or throughout the term, of that holder’s interest, or, in the case of a revocable interest described in §25.2702-2(a)(6), the transferor’s right to revoke the qualified interest of that transferor’s spouse.

* * * * *

(4) *Term of the annuity or unitrust interest*. The governing instrument must fix the term of the annuity or unitrust and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the holder, for a specified term of years, or for the shorter (but not the longer) of those periods. * * *

(5) *Commutation*. The governing instrument must prohibit commutation (prepayment) of the interest of the holder.

* * * * *

(e) * * *

Example 5. * * * The interest of A (and A’s estate) to receive the unitrust amount for the specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years.

Example 6. *** As in *Example 5*, the interest of A (and A's estate) to receive the unitrust amount for a specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years. However, the right of A's estate to continue to receive the unitrust amount after the expiration of the 10-year term if A dies within that 10-year period is not fixed and ascertainable at the creation of the interest and is not a qualified unitrust interest.

Example 8. A transfers property to an irrevocable trust, retaining the right to receive an annuity equal to 6 percent of the initial net fair market value of the trust property for 10 years, or until A's prior death. At the expiration of the 10-year term, or on A's death prior to the expiration of the 10-year term, the annuity is to be paid to B, A's spouse, if then living, for 10 years or until B's prior death. A retains an *inter vivos* and testamentary power to revoke B's interest during the initial 10-year term. If not exercised by A during the initial 10-year term (whether during A's life or on A's death), A's right to revoke B's interest will lapse upon either A's death during the 10-year term, or the expiration of A's 10-year term (assuming A survives the term). Upon expiration of B's interest (or on the expiration of A's interest if A revokes B's interest or if B predeceases A), the trust terminates and the trust corpus is payable to A's child. Because A has made a completed gift of the remainder interest, the transfer of property to the trust is not incomplete as to all interests in the property and section 2702 applies. A's annuity interest (A's right to receive the annuity for 10 years, or until A's prior death) is a retained interest that is a qualified annuity interest under paragraphs (b) and (d) of this section. In addition, because A has retained the power to revoke B's interest, B's interest is treated as an interest retained by A for purposes of section 2702. B's successive annuity interest otherwise satisfies the requirements for a qualified interest contained in paragraph (d) of this section, but for A's power to revoke. The term of B's interest is specified in the governing instrument and is fixed and ascertainable at the creation of the trust, and B's right to receive the annuity is contingent only on B's survival, and A's power to revoke. Following the expiration of A's interest, the annuity is to be paid for a 10-year term or for B's (the successor holder's) life, whichever is shorter. Accordingly, A is treated as retaining B's revocable qualified annuity interest pursuant to §25.2702-2(a)(6). Because both A's interest and B's interest are treated as qualified interests retained by A, the value of the gift is the value of the property transferred to the trust less the value of both A's qualified interest and B's qualified interest (subject to A's power to revoke), each valued as a single-life annuity. If A survives the 10-year term without having revoked B's interest, then A's power to revoke lapses and A will make a completed gift to B at that time. Further, if A revokes B's interest prior to the commencement of that interest, A is treated as making an additional completed gift at that time to A's child. In either case, the amount of the gift would be the present value of B's interest determined under section 7520 and the applicable regulations, as of the date the revocation power lapses or the interest is revoked. See §25.2511-2(f).

Example 9. (i) A transfers property to an irrevocable trust, retaining the right to receive 6 percent of

the initial net fair market value of the trust property for 10 years, or until A's prior death. If A survives the 10-year term, the trust terminates and the trust corpus is payable to A's child. If A dies prior to the expiration of the 10-year term, the annuity is payable to B, A's spouse, if then living, for the balance of the 10-year term, or until B's prior death. A retains the right to revoke B's interest. Upon expiration of B's interest (or upon A's death if A revokes B's interest or if B predeceases A), the trust terminates and the trust corpus is payable to A's child. As is the case in *Example 8*, A's retained annuity interest (A's right to receive the annuity for 10 years, or until A's prior death) is a qualified annuity interest under paragraphs (b) and (d) of this section. However, B's interest does not meet the requirements of paragraph (d) of this section. The term of B's annuity is not fixed and ascertainable at the creation of the trust, because it is not payable for the life of B, a specified term of years, or for the shorter of those periods. Rather, B's annuity is payable for an unspecified period that will depend upon the number of years left in the original term after A's death. Further, B's annuity is payable only if A dies prior to the expiration of the 10-year term. Thus, payment of B's annuity is not dependent solely on B's survival, but rather is dependent on A's failure to survive.

(ii) Accordingly, the amount of the gift is the fair market value of the property transferred to the trust reduced by the value of A's qualified interest (A's right to receive the stated annuity for 10 years or until A's prior death). B's interest is not a qualified interest and is thus valued at zero under section 2702.

Par. 5. Section 25.2702-7 is amended by adding two sentences at the end of the section to read as follows:

§25.2702-7 *Effective dates.*

*** Section 25.2702-2(a)(5), the second and third sentences of §25.2702-2(a)(6), §25.2702-3(d)(2), the first two sentences of §25.2702-3(d)(4), the last sentence of §25.2702-3(e), *Example 5*, the last two sentences of §25.2702-3(e), *Example 6*, and §25.2702-3(e), *Examples 8* and *9*, apply for trusts created on or after July 26, 2004. However, the Internal Revenue Service will not challenge any prior application of the changes to *Examples 5* and *6* in §25.2702-3(e).

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

Approved February 15, 2005.

Eric Solomon,
*Acting Deputy Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on February 24, 2005, 8:45 a.m., and published in the issue of the Federal Register for February 25, 2005, 70 F.R. 9222)

Section 6621.—Determination of Rate of Interest

26 CFR 301.6621-1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning April 1, 2005, will be 6 percent for overpayments (5 percent in the case of a corporation), 6 percent for underpayments, and 8 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 will be 3.5 percent.

Rev. Rul. 2005-15

Section 6621 of the Internal Revenue Code establishes the rates for interest on tax overpayments and tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 3 percentage points (2 percentage points in the case of a corporation), except the rate for the portion of a corporate overpayment of tax exceeding \$10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under section 6601 on any large corporate underpayment, the underpayment rate under section 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See section 6621(c) and section 301.6621-3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and section 301.6621-3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under section 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) provides that in determining the addition to tax under section 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate that applies during the third month following such taxable year also applies during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section

6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of January 2005 is 3 percent. Accordingly, an overpayment rate of 6 percent (5 percent in the case of a corporation) and an underpayment rate of 6 percent are established for the calendar quarter beginning April 1, 2005. The overpayment rate for the portion of a corporate overpayment exceeding \$10,000 for the calendar quarter beginning April 1, 2005, is 3.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning April 1, 2005, is 8 percent. These rates apply to amounts bearing interest during that calendar quarter.

Under section 6621(b)(2)(B), the 5 percent rate that applies to estimated tax un-

derpayments for the first calendar quarter in 2005, as provided by Rev. Rul. 2004-111, 2004-51 I.R.B. 989, also applies to such underpayments for the first 15 days in April 2005.

Interest factors for daily compound interest for annual rates of 3.5 percent, 5 percent, 6 percent, and 8 percent are published in Tables 12, 15, 17, and 21 of Rev. Proc. 95-17, 1995-1 C.B. 556, 566, 569, 571, and 575.

Annual interest rates to be compounded daily pursuant to section 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Crystal Foster of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue ruling, contact Ms. Foster at (202) 622-7326 (not a toll-free call).

TABLE OF INTEREST RATES		
PERIODS BEFORE JUL. 1, 1975 — PERIODS ENDING DEC. 31, 1986		
OVERPAYMENTS AND UNDERPAYMENTS		
PERIOD	RATE	In 1995-1 C.B. DAILY RATE TABLE
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25, pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 — Dec. 31, 1998

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577
Apr. 1, 1997—Jun. 30, 1997	8%	21	575	9%	23	577
Jul. 1, 1997—Sep. 30, 1997	8%	21	575	9%	23	577
Oct. 1, 1997—Dec. 31, 1997	8%	21	575	9%	23	577
Jan. 1, 1998—Mar. 31, 1998	8%	21	575	9%	23	577
Apr. 1, 1998—Jun. 30, 1998	7%	19	573	8%	21	575
Jul. 1, 1998—Sep. 30, 1998	7%	19	573	8%	21	575
Oct. 1, 1998—Dec. 31, 1998	7%	19	573	8%	21	575

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 — PRESENT
NONCORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	RATE	1995-1 C.B. TABLE	PG
Jan. 1, 1999—Mar. 31, 1999	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	6%	17	571

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 — PRESENT
CORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1999—Mar. 31, 1999	6%	17	571	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	7%	19	573	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	7%	19	573	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	7%	19	573	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	7%	67	621	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	8%	69	623	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	8%	69	623	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	8%	69	623	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	8%	21	575	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	7%	19	573	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	6%	17	571	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	6%	17	571	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	5%	15	569	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	5%	15	569	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	5%	15	569	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	5%	15	569	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	4%	13	567	5%	15	569

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 — PRESENT — Continued
CORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PG
Apr. 1, 2003—Jun. 30, 2003	4%	13	567	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	4%	13	567	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	3%	11	565	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	3%	59	613	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	4%	61	615	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	3%	59	613	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	4%	61	615	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	4%	13	567	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	5%	15	569	6%	17	571

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 — PRESENT

	RATE	1995-1 C.B.	PG
		TABLE	
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581
Jan. 1, 1998—Mar. 31, 1998	11%	27	581
Apr. 1, 1998—Jun. 30, 1998	10%	25	579
Jul. 1, 1998—Sep. 30, 1998	10%	25	579
Oct. 1, 1998—Dec. 31, 1998	10%	25	579
Jan. 1, 1999—Mar. 31, 1999	9%	23	577
Apr. 1, 1999—Jun. 30, 1999	10%	25	579
Jul. 1, 1999—Sep. 30, 1999	10%	25	579
Oct. 1, 1999—Dec. 31, 1999	10%	25	579

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 — PRESENT – Continued

	RATE	1995-1 C.B. TABLE	PG
Jan. 1, 2000—Mar. 31, 2000	10%	73	627
Apr. 1, 2000—Jun. 30, 2000	11%	75	629
Jul. 1, 2000—Sep. 30, 2000	11%	75	629
Oct. 1, 2000—Dec. 31, 2000	11%	75	629
Jan. 1, 2001—Mar. 31, 2001	11%	27	581
Apr. 1, 2001—Jun. 30, 2001	10%	25	579
Jul. 1, 2001—Sep. 30, 2001	9%	23	577
Oct. 1, 2001—Dec. 31, 2001	9%	23	577
Jan. 1, 2002—Mar. 31, 2002	8%	21	575
Apr. 1, 2002—Jun. 30, 2002	8%	21	575
Jul. 1, 2002—Sep. 30, 2002	8%	21	575
Oct. 1, 2002—Dec. 30, 2002	8%	21	575
Jan. 1, 2003—Mar. 31, 2003	7%	19	573
Apr. 1, 2003—Jun. 30, 2003	7%	19	573
Jul. 1, 2003—Sep. 30, 2003	7%	19	573
Oct. 1, 2003—Dec. 31, 2003	6%	17	571
Jan. 1, 2004—Mar. 31, 2004	6%	65	619
Apr. 1, 2004—Jun. 30, 2004	7%	67	621
Jul. 1, 2004—Sep. 30, 2004	6%	65	619
Oct. 1, 2004—Dec. 31, 2004	7%	67	621
Jan. 1, 2005—Mar. 31, 2005	7%	19	573
Apr. 1, 2005—Jun. 30, 2005	8%	21	575

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING \$10,000
FROM JANUARY 1, 1995 — PRESENT

	RATE	1995-1 C.B. TABLE	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572
Jan. 1, 1998—Mar. 31, 1998	6.5%	18	572
Apr. 1, 1998—Jun. 30, 1998	5.5%	16	570
Jul. 1, 1998—Sep. 30, 1998	5.5%	16	570
Oct. 1, 1998—Dec. 31, 1998	5.5%	16	570
Jan. 1, 1999—Mar. 31, 1999	4.5%	14	568
Apr. 1, 1999—Jun. 30, 1999	5.5%	16	570
Jul. 1, 1999—Sep. 30, 1999	5.5%	16	570
Oct. 1, 1999—Dec. 31, 1999	5.5%	16	570
Jan. 1, 2000—Mar. 31, 2000	5.5%	64	618
Apr. 1, 2000—Jun. 30, 2000	6.5%	66	620
Jul. 1, 2000—Sep. 30, 2000	6.5%	66	620
Oct. 1, 2000—Dec. 31, 2000	6.5%	66	620

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING \$10,000
FROM JANUARY 1, 1995 — PRESENT — Continued

	RATE	1995-1 C.B. TABLE	PG
Jan. 1, 2001—Mar. 31, 2001	6.5%	18	572
Apr. 1, 2001—Jun. 30, 2001	5.5%	16	570
Jul. 1, 2001—Sep. 30, 2001	4.5%	14	568
Oct. 1, 2001—Dec. 31, 2001	4.5%	14	568
Jan. 1, 2002—Mar. 31, 2002	3.5%	12	566
Apr. 1, 2002—Jun. 30, 2002	3.5%	12	566
Jul. 1, 2002—Sep. 30, 2002	3.5%	12	566
Oct. 1, 2002—Dec. 31, 2002	3.5%	12	566
Jan. 1, 2003—Mar. 31, 2003	2.5%	10	564
Apr. 1, 2003—Jun. 30, 2003	2.5%	10	564
Jul. 1, 2003—Sep. 30, 2003	2.5%	10	564
Oct. 1, 2003—Dec. 31, 2003	1.5%	8	562
Jan. 1, 2004—Mar. 31, 2004	1.5%	56	610
Apr. 1, 2004—Jun. 30, 2004	2.5%	58	612
Jul. 1, 2004—Sep. 30, 2004	1.5%	56	610
Oct. 1, 2004—Dec. 31, 2004	2.5%	58	612
Jan. 1, 2005—Mar. 31, 2005	2.5%	10	564
Apr. 1, 2005—Jun. 30, 2005	3.5%	12	566

Part III. Administrative, Procedural, and Miscellaneous

Guidance Related to Section 936 Termination

Notice 2005-21

This notice provides guidance to U.S. corporations allowed a credit under section 936 or 30A of the Internal Revenue Code (section 936 corporations) with regard to the termination of sections 936 and 30A. Specifically, this notice discusses certain issues that are likely to arise depending on the manner in which the business of a section 936 corporation continues to be conducted after this termination.

BACKGROUND

Subject to certain limitations, special tax credits are available under section 936 (possession tax credit) or section 30A (Puerto Rico Economic Activity Credit) for taxable income of a domestic corporation derived from the active conduct of a trade or business in a possession of the United States, provided that an election is made under sections 936(a) and (e). The tax credits provided by sections 936 and 30A will not be allowed for taxable years beginning after December 31, 2005. See sections 936(j) and 30A(h). The Treasury Department and the Internal Revenue Service (Service) anticipate that certain issues are likely to arise in connection with the termination of sections 936 and 30A (including election revocations in advance of such termination) and accordingly provide guidance with respect to these issues in this notice. The Treasury Department and the Service intend that these issues be resolved by applying existing provisions of the Internal Revenue Code and the Treasury regulations. This notice provides explanations and cross-references as appropriate to certain applicable statutory and regulatory provisions. Other issues not discussed in this notice may also arise, depending on a specific taxpayer's facts and circumstances.

Whether certain issues are likely to arise will depend on the manner in which a section 936 corporation's business continues to be conducted following the termination of sections 936 and 30A. Three possible situations and the issues that are

likely to arise in each are discussed in Sections I through III below.

Regardless of how a section 936 corporation's business is conducted following the termination of sections 936 and 30A, in the case of a section 936 corporation that does not affirmatively revoke its election to be treated as a section 936 corporation and has not otherwise allowed the election to terminate (for example, by not claiming the possession tax credit on Form 5735 ("Possessions Corporation Tax Credit (Under Sections 936 and 30A)")), the election will terminate by operation of law for the taxable years of such corporation beginning after December 31, 2005. No new filing requirements (for example, a requirement to file a special form) will apply to such a corporation.

SECTION I. THE SECTION 936 CORPORATION CONTINUES ITS ACTIVITIES AS A DOMESTIC CORPORATION.

One possible situation upon the termination of sections 936 and 30A (or earlier election revocation) is for the former section 936 corporation to continue its activities as a domestic corporation.

A. Membership in consolidated group

For taxable years following the last taxable year in which it was entitled to the credit under section 936 or 30A, a former section 936 corporation that continues its activities as a domestic corporation may be required to be included in an affiliated group of corporations filing a consolidated income tax return. Section 1504(b)(4) provides that section 936 corporations are not "includible corporations" that may join in a consolidated return group. If the section 936 corporation would have been includible in a consolidated return group were it not for section 1504(b)(4), the termination of sections 936 and 30A will automatically cause the corporation to be included in the consolidated return group for the first taxable year it is not a section 936 corporation. No election needs to be filed, and no approval from the Service needs to be obtained, to include the former section 936 corporation in the consolidated return group. If the section 936

corporation and its parent corporation do not have the same annual accounting period, the inclusion of the former section 936 corporation in the consolidated return group will result in a short taxable year for the former section 936 corporation. See Rev. Proc. 2002-37, 2002-1 C.B. 1030, and Rev. Proc. 2002-39, 2002-1 C.B. 1046, for guidance on changes to annual accounting periods.

When the former section 936 corporation becomes an includible corporation, the parent corporation is the agent for the group for many elections and other matters related to the tax liability of the former section 936 corporation and the other consolidated return group members. See § 1.1502-77 of the Income Tax Regulations.

If the former section 936 corporation becomes includible in a consolidated return group, the carryover of specific tax attributes of the corporation will be governed by applicable consolidated return provisions. The special rules governing prior losses and earnings are discussed below.

B. Former section 936 corporation with loss history

Each taxable year that the corporation was a section 936 corporation is a separate return limitation year (SRLY) in relation to the consolidated return group. See § 1.1502-1(f). Therefore, the rules of § 1.1502-21(c) will limit the extent to which net operating loss (NOL) carryovers of the former section 936 corporation arising (or treated as arising) in its SRLYs are included in the consolidated NOL deductions for the years the corporation is included in the consolidated return group. In general, § 1.1502-21(c)(1) provides that NOLs from SRLYs included in the group's consolidated NOL deduction may not exceed the aggregate consolidated taxable income for all consolidated taxable years of the group determined by reference to only the member's items of income, gain, deduction, and loss, as explained in the regulation. Under § 1.1502-15, built-in losses of the former section 936 corporation arising (or treated as arising) in its SRLYs may, in some cases, be limited by the SRLY limitation described above

as if the built-in loss were a hypothetical NOL carryover or net capital loss carryover arising in a SRLY. SRLY limitations also apply to net capital losses (*see* § 1.1502-22(c)), net section 1231 losses (*see* § 1.1502-23), general business credits (*see* § 1.1502-3(d)), and minimum tax credits (*see* § 1.1502-55).

If a former section 936 corporation (whether or not includible in a consolidated return group) continues its activities as a domestic corporation, section 382 will not apply to limit the carryover of NOLs or built-in losses in the absence of an “ownership change” (as defined in section 382(g)). The termination of sections 936 and 30A or the revocation of a section 936 election alone will not constitute an ownership change for that purpose.

If the section 936 corporation is an unaffiliated dual resident corporation or an unaffiliated domestic owner that has filed an agreement described in § 1.1503-2(g)(2) with respect to dual consolidated losses, becoming a member of a consolidated group may cause the dual consolidated losses to be recaptured pursuant to § 1.1503-2(g)(2)(iii)(A).

C. Accumulated earnings of section 936 corporation

When a former section 936 corporation becomes a member of a consolidated return group, the treatment of the earnings and profits (E&P) of the former section 936 corporation will be determined by the rules provided in § 1.1502-33. When the former section 936 corporation joins the consolidated group, any undistributed E&P earned before it was a member of the consolidated return group carry over to the corporation’s first taxable year in the group, and E&P earned after it becomes a member of the group will tier up to higher-tier corporations in the group under § 1.1502-33(b). When a former section 936 corporation becomes an includible corporation in a consolidated return group and distributes a dividend to its parent corporation attributable to E&P accumulated while the distributing corporation was a section 936 corporation, such a dividend will not result in an adjusted current earnings (ACE) adjustment under section 56(g)(4)(C) for alternative minimum tax (AMT) purposes. For regular tax purposes, such a dividend is not included in

the parent corporation’s gross income under § 1.1502-13(f)(2)(ii), and there is no change to the parent corporation’s E&P as a result of such a distribution.

SECTION II. THE SECTION 936 CORPORATION LIQUIDATES INTO ITS DOMESTIC PARENT CORPORATION.

Another possible situation upon the termination of sections 936 and 30A (or earlier election revocation) is for the section 936 corporation to be completely liquidated into its domestic parent corporation.

A. Recognition of gain or loss upon liquidation distributions

Section 332(a) provides, subject to the requirements in section 332(b), that no gain or loss is recognized on receipt by a corporation of property distributed in complete liquidation of another corporation. Section 337(a) provides that no gain or loss is recognized to the liquidating corporation on the distribution of any property to the 80-percent distributee (that is, the corporation that meets the 80-percent stock ownership requirements in section 332(b)) in a complete liquidation to which section 332 applies. If the section 936 corporation has one corporate shareholder that satisfies the requirements of an 80-percent distributee, sections 332(a) and 337(a) allow the corporation to be liquidated into its parent corporation without recognition of gain or loss by either the liquidating section 936 corporation or its parent corporation. *But see* section 337(c) (denying section 337 nonrecognition, but not section 332 nonrecognition, if the liquidating corporation is owned by two or more members of a consolidated group that together meet the 80-percent ownership requirements by reason of the aggregate stock ownership rule of § 1.1502-34).

Section 901(g)(1) provides a special rule for taxes paid or accrued to foreign countries or possessions of the United States with respect to distributions that are attributable to periods during which the distributing corporation was a “possessions corporation.” For this purpose, the term “possessions corporation” includes section 936 corporations. *See* section 901(g)(2). Under this special rule, to the extent the distribution is received in connection with a liquidation with respect to

which gain or loss is not recognized, such taxes shall not be treated as taxes paid to a foreign country or U.S. possession. As a result, no foreign tax credit or deduction shall be allowed with respect to any amount so paid or accrued.

If the section 936 corporation is an unaffiliated dual resident corporation or an unaffiliated domestic owner that has filed an agreement described in § 1.1503-2(g)(2) with respect to dual consolidated losses, the liquidation of such corporation may cause the dual consolidated losses to be recaptured pursuant to § 1.1503-2(g)(2)(iii)(A).

B. Succession to section 381(c) items of the liquidated section 936 corporation

In the case of the acquisition of assets of a corporation by another corporation in a distribution to such other corporation to which section 332 applies, section 381 provides that the acquiring corporation shall succeed to and take into account, as of the close of the day of the distribution and subject to certain conditions and limitations, the items described in section 381(c). Section 381(c) enumerates more than twenty separate items, which include (but are not limited to) NOL carryovers, E&P, capital loss carryovers, and methods of accounting. When a section 936 corporation is liquidated into its parent corporation under section 332, section 381 requires that the parent corporation determine and take into account the items specified in section 381(c).

Section 381(c)(1) provides rules regulating the carryover of an NOL of a liquidating corporation to its parent corporation’s first taxable year ending after the date of the liquidation. In particular, section 381(c)(1)(B) limits the deductibility of the NOL carryover for that taxable year of the parent to the proportion of the parent’s taxable income that the number of days in the taxable year after the liquidation bears to the total number of days in the year. Also, section 381(b)(3) provides that the parent corporation may not carry back an NOL or a net capital loss for a taxable year ending after the date of the liquidation to a taxable year of the liquidated corporation.

If the parent corporation is a member of a consolidated return group, NOLs, built-in losses, and other tax attributes to

which the parent corporation of a liquidated section 936 corporation succeeds are subject to the SRLY rules. The SRLY limitation applies to a carryover of NOLs from the subsidiary under § 1.1502-21, to built-in losses on assets distributed by the subsidiary under § 1.1502-15, and to certain other carryovers. All of the items of income, gain, deduction, and loss of the parent (that is, not solely the items attributable to the assets distributed by the subsidiary) are included for purposes of determining the SRLY limitation for the parent's taxable years after a section 332 liquidation. *See* § 1.1502-15(d), Example 1, part (iv) (applying a similar rule when assets are contributed to a corporation in a section 351 transaction).

The ACE adjustment under section 56(g)(4)(C) does not apply to a liquidation of a section 936 corporation into its parent corporation because, under section 331(b), a distribution in liquidation is not treated as a dividend.

SECTION III. THE SECTION 936 CORPORATION REINCORPORATES AS A FOREIGN CORPORATION.

A third possible situation upon the termination of sections 936 and 30A (or earlier election revocation) is for the section 936 corporation (or former section 936 corporation) to reincorporate as a foreign corporation. For these purposes, a foreign corporation includes a corporation formed under the laws of a possession of the United States. *See* section 7701(a)(5).

A. Section 367 consequences of a section 368(a)(1)(F) reorganization

A common form of reincorporation is effected through "a mere change in identity, form, or place of organization of one corporation, however effected," as described in section 368(a)(1)(F) (an "F reorganization"). Section 1.367(a)-1T(f) provides that, in every F reorganization where the transferor corporation is a domestic corporation and the acquiring corporation is a foreign corporation, there is considered to exist: (1) a transfer of assets by the transferor corporation to the acquiring corporation under section 361(a) in exchange for stock of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation's

liabilities; (2) a distribution of the stock of the acquiring corporation by the transferor corporation to the shareholders of the transferor corporation; and (3) an exchange by the transferor corporation's shareholders of the stock of the transferor corporation for stock of the acquiring corporation under section 354(a).

Section 367(a) provides that, if in connection with any exchange described in section 361(a) a U.S. person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain will be recognized on such transfer, be considered a corporation. The transferee's loss of corporate status for U.S. tax purposes denies the transferor the benefit of non-recognition treatment with respect to gain under section 361(a). A domestic corporation subject to gain recognition under section 367(a) recognizes gain on the transfer of its assets to a foreign corporation in a transaction described in section 361(a) as if the property had been disposed of in a taxable exchange with the transferee corporation. *See* § 1.367(a)-1T(b)(4). Section 367(a)(2) and (3), and the regulations thereunder, provide special exceptions to the rule of gain recognition provided in section 367(a)(1) when a U.S. person transfers certain types of property to a foreign corporation, including a limited exception for property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside the United States. This exception, however, does not apply to certain kinds of property, such as section 1221(a) inventory property or accounts receivable. These special exceptions also do not apply in certain cases where the transferor corporation is widely held. *See* section 367(a)(5).

Section 367 generally will apply to transfers of property by a section 936 corporation to a foreign corporation without regard to whether the section 936 election is in effect at the time of the transfer. However, if the transfer is made while the section 936 election is in effect, the taxpayer may receive a possession tax credit with respect to income recognized on the transfer, to the extent such income is from sources outside the United States. *See* sections 936(a)(1)(A)(ii) and 30A(a)(1)(B).

B. Effect of termination of section 936 on the use and transfer of intangibles

Section 367(d) provides that, if a U.S. person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361, the U.S. person transferring such property shall be treated as having sold such intangible property in exchange for a series of annual payments over the useful life of such property which are contingent upon the productivity, use, or disposition of such property and which are commensurate with the income attributable to such property. These deemed payments are treated as ordinary income to the transferor.

Section 367(d) does not apply to the transfer of foreign goodwill or going concern value. Section 1.367(d)-1T(b). For this purpose, § 1.367(a)-1T(d)(5)(iii) defines "foreign goodwill or going concern value" as "the residual value of a business operation conducted outside the United States after all other tangible and intangible assets have been identified and valued." The transfer of a section 936 corporation's business to a foreign corporation typically will not involve the transfer of significant goodwill of the section 936 corporation to the foreign corporation, but it may in certain cases. Goodwill associated with a section 936 corporation's business operations in a possession, to the extent it exists, may or may not be considered "foreign goodwill" under § 1.367(a)-1T(d)(5)(iii), depending on the facts and circumstances.

Section 936 contains special rules regarding intangibles that may affect the application of section 367(d) to transfers of intangibles by a section 936 corporation or former section 936 corporation.

Section 936(h) provides that the intangible property income of a section 936 corporation — that is, the gross income of a section 936 corporation attributable to any intangible property (other than intangible property that has been licensed to the section 936 corporation since prior to 1948) — shall be included on a *pro rata* basis in the gross income of the shareholders of the section 936 corporation as income from sources within the United States. Under section 936(h)(5), however, the shareholders of a section 936 corpo-

ration are not required to recognize such intangible property income if an eligible section 936 corporation elects one of two alternative methods of computation of taxable income: (1) the cost sharing method of section 936(h)(5)(C)(i) (“section 936 CSM”); or (2) the profit split method of section 936(h)(5)(C)(ii) (“section 936 profit split method”). Under the section 936 CSM, the electing section 936 corporation pays a “cost sharing payment” (as defined in section 936(h)(5)(C)(i)(I)) and is treated as an owner (solely for purposes of earning a return thereon) of certain intangible property related to the section 936 corporation’s economic activities in the possession. Under the section 936 profit split method, the electing section 936 corporation’s taxable income is equal to 50 percent of the section 936(h)(5)(C)(ii)(II) “combined taxable income” of the affiliated group from covered sales of products produced or services rendered, in whole or in part, by the section 936 corporation in a possession.

Following the termination of sections 936 and 30A, the section 936 CSM and the section 936 profit split method will no longer apply and the income of a former section 936 corporation (or a successor entity), including income from intangibles, will be required to be determined under generally applicable federal income tax principles. Thus, for example, the arm’s length amount charged in a controlled transfer of an intangible to a former section 936 corporation must be determined under one of the four methods listed in § 1.482-4(a), applied in accordance with all of the provisions of § 1.482-1, and must be commensurate with the income attributable to the intangible. In this regard, it is important to note that Congress intended for cost sharing under section 936(h)(5)(C)(i) to remain separate and distinct from cost sharing arrangements under section 482. See section 936(h)(5)(C)(i)(I) (providing that amounts paid under cost sharing agreements with related persons are not considered in the determination of section 936 CSM payments). A section 936 corporation does not obtain an interest in intangibles in exchange for payments it makes pursuant to an election of the section 936 CSM, but rather, it obtains a temporary limited entitlement to manufacturing intangible income. See section 936(h)(5)(C)(i)(II). That is, the statutorily

determined section 936 CSM payment entitles the section 936 corporation to manufacturing intangible income only in the taxable year for which the payment is made. A section 936 corporation or a former section 936 corporation will accordingly not possess any interest in any intangible property as a result of payments made pursuant to an election of the section 936 CSM.

To the extent that a section 936 corporation (or a former section 936 corporation) does own intangible property (“possession-owned intangibles”), and transfers such property to a foreign corporation, certain of the section 367 consequences may depend on whether the section 936 election is in effect at the time of the property transfer. Under section 936(h)(6), when a section 936 corporation transfers possession-owned intangibles to a related foreign corporation, the shareholders of the section 936 corporation are generally required by section 936(h)(1) to include in gross income, on a *pro rata* basis, the annual payments provided for by section 367(d) as U.S. source ordinary income. In contrast, if a section 936 election is not in effect at the time of the transfer (for example, following the termination of sections 936 and 30A), the transferor of possession-owned intangibles (that is, a former section 936 corporation or a successor corporation) to a foreign corporation will itself be treated as having sold such possession-owned intangibles in exchange for the annual payments provided for by section 367(d), with the source of such payments generally determined by the applicable source rule in section 861(a)(4) or 862(a)(4), pursuant to section 865(d).

C. Subsequent dividends from earnings accumulated by the section 936 corporation

In a transfer connected with an F reorganization to which section 361 applies, section 381 provides that the acquiring corporation shall succeed to and take into account, as of the close of the day of the distribution and subject to certain conditions and limitations, the items described in section 381(c), which include E&P. See section 381(c)(2). Section 243(e) provides that any dividend from a foreign corporation from E&P accumulated by a domestic corporation during a period with respect to

which the domestic corporation was subject to taxation shall be entitled to a DRD as if it were distributed by a domestic corporation which is subject to taxation for purposes of applying section 243(a). Notwithstanding that section 936 provides for a credit against taxes imposed on a corporation making a section 936 election, section 936 corporations are domestic corporations subject to tax and thus meet the requirements of sections 243(a) and (e). Section 243(a) provides a 100-percent dividends received deduction (DRD) for qualifying dividends. Section 243(b) provides that a qualifying dividend includes any dividend received by a corporation if the corporation is a member of the same affiliated group as the distributing corporation and the distributing corporation has a section 936 election in effect. For this purpose, the exclusion of a section 936 corporation from the affiliated group under section 1504(b)(4) does not apply. See section 243(b)(2)(A).

Section 1.243-3(b) provides that a foreign corporation shall, for purposes of section 243(e), maintain separate accounts for E&P to which it succeeds that were accumulated by a domestic corporation and for other accumulated E&P of the foreign corporation. Under § 1.316-2, every distribution made by a corporation is considered to be made first out of any current year E&P and then out of E&P accumulated in prior taxable years. With respect to the accumulated E&P of the foreign corporation, § 1.243-3(c) provides that dividends paid by the foreign corporation shall be treated as having been paid out of the most recently accumulated E&P of such foreign corporation (regardless of whether such E&P was accumulated by a predecessor domestic corporation or by the foreign corporation itself). To the extent that a dividend is paid out of E&P accumulated by the foreign corporation and by a predecessor domestic corporation for taxable years ending on the same day (so that neither is more recently accumulated), then the portion of such dividend considered paid out of each account shall be the same proportion of the total dividend as the amount of E&P in that account bears to the sum of the E&P in all such accounts. Thus, for example, if a section 936 corporation is reincorporated as a newly formed foreign corporation, and the foreign corporation subsequently makes distributions

to its U.S. parent, the distributions will be treated as first coming from current E&P, then from accumulated E&P with the latest E&P accumulated being treated as distributed first. Subject to section 245, dividends from earnings accumulated by the foreign corporation itself generally will not be entitled to the DRD. However, dividends from E&P accumulated while the predecessor corporation was a section 936 corporation will be entitled to the DRD.

Section 901(g)(1) provides in relevant part that no credit or deduction is allowed for any tax that is paid or accrued to any foreign country or possession of the United States with respect to any distribution from a corporation to the extent such distribution is attributable to periods during which such corporation is a section 936 corporation and a DRD is allowable with respect to such distribution. As a result, no foreign tax credit or deduction is allowed with respect to any foreign or possession tax imposed on dividend distributions by a foreign corporation from earnings accumulated by a predecessor section 936 corporation.

D. Alternative minimum tax

In determining ACE adjustments for AMT purposes, section 56(g)(4)(C)(i) generally provides that a deduction shall not be allowed for any item if such item would not be deductible for any taxable year for purposes of computing E&P. However, section 56(g)(4)(C)(ii) provides an exception for any deduction allowable under section 243 for any dividend that is a "100-percent dividend" (that is, a dividend with respect to which a 100-percent DRD is allowable), or that is received from a section 243(c)(2) "20-percent owned corporation," but only to the extent such dividend is attributable to income of the paying corporation that is subject to tax (determined after the application of sections 936 and 30A). Thus, to determine the effect on ACE of a distribution from a foreign corporation that has succeeded to the E&P of a section 936 corporation, the recipient of the distribution must determine: (1) the extent to which the section 243 DRD would be allowed with respect to the distribution by the foreign corporation; and (2) the extent to which the E&P comprising such distribution were accumulated in taxable years for which

the election under section 936 (or section 30A) was in effect and were subject to tax in such taxable years.

For purposes of determining the alternative minimum foreign tax credit, section 56(g)(4)(C)(iii)(I) provides, subject to the limitation in section 56(g)(4)(C)(iii)(II), that 75 percent of any withholding or income taxes paid to a possession of the United States shall be treated as a tax paid to a foreign country by the corporation receiving the dividend. Taxes paid to a U.S. possession by a section 936 corporation shall be treated as a withholding tax paid with respect to any dividend distributed by such corporation to the extent such taxes would be treated as paid by the corporation receiving the dividend under rules similar to the rules of section 902. Section 56(g)(4)(C)(iii)(III). Section 56(g)(4)(C)(iii)(IV) provides that, in determining the alternative minimum foreign tax credit, section 904(d) shall be applied as if dividends from a section 936 corporation were a separate category of income referred to in a subparagraph of section 904(d)(1). To the extent a dividend distributed by a foreign corporation comprises E&P accumulated in taxable years for which an election under section 936 (or section 30A) was in effect (and to which the foreign corporation has succeeded), the recipient of the dividend will determine the alternative minimum foreign tax credit with respect to such part of the dividend pursuant to the rules provided in section 56(g)(4)(C)(iii).

E. Recapture of dual consolidated losses

If the section 936 corporation is an unaffiliated dual resident corporation or an unaffiliated domestic owner that has filed an agreement described in § 1.1503-2(g)(2) with respect to dual consolidated losses, an outbound asset reorganization may cause the dual consolidated losses to be recaptured pursuant to § 1.1503-2(g)(2)(iii)(A). Depending on the facts and circumstances, recapture issues in addition to those associated with dual consolidated losses may also arise. See sections 367(a)(3)(C) and 904(f)(3).

F. Reporting requirements

Depending on the facts and circumstances, certain reporting requirements

may apply with respect to the former section 936 corporation. For example, section 6038B may require the transfer of tangible and intangible property to be reported on Form 926 ("*Return by a U.S. Transferor of Property to a Foreign Corporation*"). See § 1.6038B-1. Form 5471 ("*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*") and its schedules (for example, Schedule O ("*Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock*")) may also be required to be filed. See generally sections 6038 and 6046.

G. Subpart F consequences to U.S. shareholders

Depending on the facts and circumstances, a section 936 corporation reincorporated as a foreign corporation may be a controlled foreign corporation (CFC) (as defined in section 957(a)) subject to the provisions of subpart F (sections 951 through 964). Section 951(a) requires that a United States shareholder (as defined in section 951(b)) of a CFC include in its gross income for the taxable year its *pro rata* share of certain items of the CFC's income ("subpart F income").

Certain taxpayers may choose to continue to conduct business in a possession through a branch of a CFC organized or created elsewhere. Such a branch may constitute a manufacturing branch for purposes of the regulations under section 954(d)(2). Under certain facts and circumstances, income derived by a CFC with a manufacturing branch located outside the country under the laws of which the CFC is organized may constitute foreign base company sales income, a form of subpart F income that the United States shareholder must include in income. See § 1.954-3(b)(4), Example (2).

DRAFTING INFORMATION

The principal author of this notice is Edward R. Barret of the Office of Associate Chief Counsel (International). However, other personnel from the Service and the Treasury Department participated in its development. For further information regarding this notice, contact

Thomas A. Vidano or Edward R. Barret at (202) 435-5265 (not a toll-free call).

Tsunamis Occurring on December 26, 2004, Designated as a Qualified Disaster Under § 139 of the Internal Revenue Code

Notice 2005-23

This notice designates the Indian Ocean tsunamis occurring on December 26, 2004, as a qualified disaster for purposes of § 139 of the Internal Revenue Code, and describes the affected areas.

TSUNAMI DISASTER

The Indian Ocean tsunamis were triggered by a magnitude 9.0 or greater earthquake off the west coast of Northern Sumatra, Indonesia. The tsunamis inflicted enormous damage throughout South Asia, Southeast Asia, and East Africa. Nearly 300,000 people were killed or are missing as a result of this disaster, and over one million were displaced from their homes. *USAID Fact Sheet No. 35* (February 18, 2005).

The world community has recognized the Indian Ocean tsunamis as one of the largest natural disasters in recent history. Many international humanitarian organizations, countries, and the United Nations have provided relief. The United States has taken steps to facilitate the delivery of relief in response to this unique disaster. *See Pres. Det. No. 2005-16, 70 Fed. Reg. 1787* (Jan. 10, 2005). In addition,

Congress enacted Pub. L. No. 109-1, 119 Stat. 3 (2005), which permits a taxpayer to treat a contribution made in January 2005 as if it were made on December 31, 2004, if it is a cash contribution made for the relief of victims in areas affected by the Indian Ocean tsunamis for which a charitable contribution deduction is allowable under § 170. This notice provides U.S. tax relief that will facilitate assistance to certain victims of the tsunamis.

QUALIFIED DISASTER RELIEF PAYMENTS EXCLUDED FROM RECIPIENT'S GROSS INCOME

Section 139(a) provides that gross income shall not include any amount received by an individual as a qualified disaster relief payment.

Section 139(b) provides that a qualified disaster relief payment includes any amount paid to or for the benefit of an individual—

(1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses (not otherwise compensated for by insurance or otherwise) incurred as a result of a qualified disaster, or

(2) to reimburse or pay reasonable and necessary expenses (not otherwise compensated for by insurance or otherwise) incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster.

Under § 139(c)(3) the term “qualified disaster” includes a disaster resulting from

an event that is determined by the Secretary to be of a catastrophic nature.

DESIGNATION AS QUALIFIED DISASTER

The Commissioner of Internal Revenue, pursuant to delegation by the Secretary, has determined that the Indian Ocean tsunamis occurring on December 26, 2004, are a catastrophic event under § 139(c)(3). Therefore, these tsunamis are designated as a qualified disaster under § 139 in the affected areas of these countries: Bangladesh, Burma, India, Indonesia, Kenya, Malaysia, Maldives, the Seychelles, Somalia, Sri Lanka, Tanzania, and Thailand.

SECTION 501(c)(3) ORGANIZATIONS

Because this notice designates the Indian Ocean tsunamis as a qualified disaster under § 139, employer-sponsored private foundations may choose to provide disaster relief to employee victims of the tsunamis. Like all organizations described in § 501(c)(3), private foundations should exercise due diligence when providing disaster relief as set forth in Publication 3833, *Disaster Relief: Providing Assistance Through Charitable Organizations*.

DRAFTING INFORMATION

The principal author of this notice is Sheldon A. Iskow of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Mr. Iskow at (202) 622-4920 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Guidance Under Section 1502; Miscellaneous Operating Rules for Successor Persons; Succession to Items of the Liquidating Corporation

REG-131128-04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 1502 that provide guidance regarding the manner in which the intercompany items of a liquidating member are succeeded to, and taken into account, in cases in which more than one distributee member acquires the assets of the liquidating corporation in a complete liquidation to which section 332 applies. This document also contains proposed regulations under section 1502 that provide guidance regarding the manner in which such distributee members succeed to the items (including items described in section 381(c)) of the liquidating corporation. These regulations apply to corporations filing consolidated returns.

DATES: Written or electronic comments and requests for a public hearing must be received by May 23, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-131128-04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-131128-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-131128-04).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations,

Jeffrey B. Fienberg or Charles M. Levy (202) 622-7770; concerning submissions and the hearing, Sonya Cruse, (202) 622-4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

The Complete Liquidation Rules

Section 332(a) provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation. Section 332(b) provides, in part, that a distribution shall be considered to be in complete liquidation only if the corporation receiving such property was, on the date of the adoption of the plan of liquidation and at all times thereafter until the receipt of the property, the owner of stock that meets the requirements of section 1504(a)(2) and the distribution is made in complete cancellation or redemption of all of the stock of the liquidating corporation. Section 1.1502-34 provides that in determining the stock ownership of a member of a group in another corporation for purposes of determining the application of section 332(b), stock owned by all of the members of the group in that other corporation shall be aggregated. Therefore, for example, if one member of a group owns 60 percent of the stock of the liquidating corporation and another member of the group owns the remaining 40 percent of the stock of the liquidating corporation, section 332 will apply to the liquidation.

Section 337(a) provides that the liquidating corporation does not recognize gain or loss on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies. For this purpose, the term "80-percent distributee" means only the corporation that meets the 80-percent stock ownership requirements of section 332(b). Under section 337(c), the determination of whether any corporation is an 80-percent distributee must be made without regard to any consolidated return regulation. Under section 336, if section 337(a) does not apply, the liquidating corporation must recognize gain or loss on the distribution of property

in complete liquidation as if such property were sold to the distributee at its fair market value. Therefore, a liquidating distribution may be taxable to the distributing corporation and tax-free to the distributees.

The Intercompany Transaction Rules

Section 1.1502-13 prescribes rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of those rules is to clearly reflect the taxable income (and tax liability) of the group by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income or consolidated tax liability. Under §1.1502-13(j)(2)(ii), if the assets of a member of the group are acquired by a successor member, the successor member succeeds to, and takes into account (under the rules of §1.1502-13), the predecessor's intercompany items. In addition, if two or more successor members acquire assets of the predecessor, the successors take into account the predecessor's intercompany items in a manner that is consistently applied and reasonably carries out the purposes of §1.1502-13 and applicable provisions of law. Section 1.1502-13(j)(2)(i) provides that any reference to a person includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor includes a transferor of assets to a transferee (the successor) in a transaction (A) to which section 381(a) applies; (B) in which substantially all of the assets of the transferor are transferred to members in a complete liquidation; or (C) in which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the basis of the transferor, but the transferee is a successor only with respect to the assets the basis of which is so determined.

The current regulations include two examples that illustrate how these rules operate when a member of a group, X, engages in a complete liquidation in which it distributes its assets to S and B, also group members. In *example 6* of §1.1502-13(j)(9), S owns 100 percent of the common stock of X and, therefore, is an 80-percent distributee without regard

to the application of §1.1502-34. B owns 100 percent of the preferred stock of X, which is described in section 1504(a)(4), and, therefore, is an 80-percent distributee only by reason of the application of §1.1502-34. X recognizes gain on the assets distributed to B. That gain, however, is not taken into account as a result of the liquidation and S succeeds to that gain.

In *example 7* of §1.1502-13(j)(9), S owns 60 percent of the X stock and B owns 40 percent of the X stock. Therefore, both S and B are 80-percent distributees only by reason of the application of §1.1502-34. X recognizes gain on the assets distributed to both S and B. That gain, however, is not taken into account as a result of the liquidation and S succeeds to X's gain on the assets distributed to B and B succeeds to X's gain on the assets distributed to S. As a result, under the acceleration rule, on the deconsolidation of either S or B, those gains would be taken into account in their entirety.

The rules illustrated by the examples reflect the concern that, under prior intercompany regulations, the assets of an acquired corporation could be broken up without a corporate level tax. See 59 FR 18011 (CO-11-91, 1994-1 C.B. 724). The IRS and Treasury Department have re-examined the current regulations and have concluded that accelerating all of the intercompany gains recognized on the liquidation of the liquidating corporation's assets in these cases is not necessary to deter mirror subsidiary transactions. Therefore, these regulations propose that each member of the group to which assets of a liquidating member are transferred succeeds to, and takes into account, the intercompany items of the liquidating member that are generated in the liquidation to the extent such items would have been reflected in investment basis adjustments to the stock of the liquidating member owned by such distributee member under the principles of §1.1502-32(c) if, immediately prior to the liquidation, any stock of the liquidating member owned by nonmembers had been redeemed by the liquidating member in exchange for the money or property distributed to that nonmember in the liquidating distribution, and then such items had been taken into account under §1.1502-13(d).

These proposed regulations also address the manner in which the distributee

members succeed to the intercompany items of the liquidating member that were not generated in the liquidating transaction. The IRS and Treasury Department have not identified a policy reason to distinguish between intercompany items that are generated in the liquidating transaction and intercompany items that are generated prior to the liquidating transaction. Therefore, these proposed regulations adopt the same rule for both of these categories of intercompany items.

Application of Section 381

Section 381(a)(1) provides that the acquiring corporation in a distribution to which section 332 applies shall succeed to, and take into account, the items of the distributor corporation (*i.e.*, liquidating corporation) that are listed in section 381(c). Section 1.381(a)-1(b)(2) provides that only a single corporation can be an acquiring corporation for purposes of section 381. Currently, there are no rules that govern which corporation succeeds to the items of the liquidating corporation when section 332 applies to more than one distributee as may happen by reason of the application of §1.1502-34 when the distributees are members of the same consolidated group. These proposed regulations include such rules.

The IRS and Treasury Department believe that it is appropriate for each distributee member, even if it is not an 80-percent distributee without regard to the application of §1.1502-34, to succeed to items of the liquidating corporation that could be used to offset the income or tax liability of the group or any member. If the liquidating corporation is a member of the group, any income or gain recognized by the liquidating corporation in connection with the liquidation will be deferred under §1.1502-13. If §1.1502-13 did not apply, that income or gain could be offset by net operating losses of the liquidating corporation or, alternatively, any tax liability resulting from the recognition of that income or gain could be offset by credits of the liquidating corporation. The operation of §1.1502-34 should not change that result. Single entity principles should control in situations in which section 332 applies to the distributee members. Therefore, these proposed regulations provide that each distributee member succeeds to the items of

the liquidating corporation that could be used to offset the income or tax liability of the group or any member (including net operating loss carryovers and capital loss carryovers) to the extent that such items would have been reflected in investment basis adjustments to the stock of the liquidating corporation owned by such distributee member under the principles of §1.1502-32(c) if, immediately prior to the liquidation, any stock of the liquidating corporation owned by nonmembers had been redeemed and then such items had been taken into account. In addition, each distributee member succeeds to the credits of the liquidating corporation (including credits under sections 38 and 53) to the extent that the items of gain, income, loss, or deduction attributable to the activities that gave rise to the credit would have been reflected in investment basis adjustments to the stock of the liquidating corporation owned by such distributee member under the principles of §1.1502-32(c) if, immediately prior to the liquidation, any stock of the liquidating corporation owned by nonmembers had been redeemed and then such items had been taken into account. For this purpose, if the liquidating corporation is not a member of the group at the time of the liquidation, these rules are applied as if the liquidating corporation had been a member of the group at that time. Finally, except to the extent that the distributee member's earnings and profits already reflect the liquidating corporation's earnings and profits, these proposed regulations provide that the earnings and profits of the liquidating corporation are allocated to each distributee member under the principles of §1.1502-32(c), treating any stock of the liquidating corporation owned by nonmembers as if it had been redeemed immediately prior to the liquidation.

With respect to items other than those that can offset the income or tax liability of the group or any member and earnings and profits, these proposed regulations provide that a distributee member that, immediately prior to the liquidation, satisfies the requirements of section 1504(a)(2) without regard to §1.1502-34 succeeds to the items of the liquidating corporation in accordance with the principles set forth in the Code (including section 381) and the regulations promulgated thereunder. This rule is consistent with the treatment of a nonconsolidated corporation that satis-

fies the ownership requirements of section 1504(a)(2) with respect to a liquidating corporation.

Finally, again with respect to items other than those that can offset the income or tax liability of the group or any member and earnings and profits, these proposed regulations provide that a distributee member that, immediately prior to the liquidation, does not own stock in the liquidating corporation meeting the requirements of section 1504(a)(2) without regard to §1.1502-34 succeeds to items of the liquidating corporation to the extent that it would have succeeded to those items if it had purchased, in a taxable transaction, the assets or businesses of the liquidating corporation that it received in the liquidation and assumed the liabilities it assumed in the liquidation. As described above, pursuant to section 336, to the extent that section 337(a) does not apply, a liquidating corporation must recognize gain or loss on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value. Although no provision of the Code states that the distributee is the purchaser of those assets, the IRS and Treasury Department believe that it is reasonable to treat the distributee as purchasing those assets for purposes of determining the attributes to which such a distributee succeeds.

Proposed Effective Date

These regulations are proposed to apply to complete liquidations that occur after the date that these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily will affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses, and, moreover, that any burden on taxpayers is min-

imal. 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 Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for Public Hearing

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

Drafting Information

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

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
§1.1502-13 also issued under 26 U.S.C. 1502. * * *

§1.1502-80 also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502-13 is amended by:

1. Adding a sentence at the end of paragraph (j)(2)(ii).

2. Adding paragraph (j)(2)(iii).
3. Redesignating paragraph (j)(9), introductory text, as paragraph (j)(9)(i).
4. Revising *Example 6* and *Example 7* of newly designated paragraph (j)(9)(i).
5. Adding paragraph (j)(9)(ii).

The revisions and additions read as follows:

§1.1502-13 Intercompany transactions.

* * * * *

(j) * * *

(2) * * *

(ii) *Intercompany items.* * * * For example, if the assets of a predecessor are acquired by more than one successor in a transaction to which section 381(a)(1) applies, each successor succeeds to, and takes into account (under the rules of this section), each of the predecessor's intercompany items (whether resulting from distributions in liquidation or otherwise) to the extent that such items would have been reflected in investment basis adjustments to the stock of the predecessor owned by that successor under the principles of §1.1502-32(c) if, immediately prior to the liquidation, any stock of the predecessor owned by nonmembers had been redeemed in exchange for the money or property distributed to that nonmember in the transaction to which section 381(a)(1) applies, and then such items had been taken into account under §1.1502-13(d).

(iii) *Effective date.* The third sentence of paragraph (j)(2)(ii) of this section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(9) *Examples.* (i) The operating rules of this paragraph (j) are illustrated generally throughout this section, and by the following examples:

* * * * *

Example 6. Liquidation—80% distributee. (i) *Facts.* B1, B2, and S are members of the same consolidated group. S has only common stock outstanding. B1 owns 80% of S's stock, and B2 owns the remaining 20%. On January 1 of Year 2, S sells two assets to another member of the group. S recognizes \$100 of gain with respect to the first asset and \$100 of loss with respect to the second asset. On July 1 of Year 3, S distributes all of its remaining assets to B1 and B2 in a complete liquidation. At the time of the liquidation, S's assets have an aggregate basis of \$0 and an aggregate value of \$100, and neither the gain nor the loss from the prior two asset sales has been taken into account under this section. Under §1.1502-34,

section 332 applies to both B1 and B2. Under section 337, S has no gain or loss from its liquidating distribution to B1. Under sections 336 and 337(c), S has a \$20 gain from its liquidating distribution to B2. On January 1 of Year 4, B2 ceases to be a member of the group.

(ii) *Succession to intercompany items.* Under the matching rule, S's \$20 gain from its liquidating distribution to B2 is not taken into account under this section as a result of the liquidation (and, therefore, is not yet reflected under §§1.1502-32 and 1.1502-33). Under the successor person rule of paragraph (j)(2)(i) of this section, B1 and B2 are both successors to S. Under paragraph (j)(2)(ii) of this section, B1 and B2 each succeeds to S's intercompany items to the extent that such items would have been reflected in investment basis adjustments to its stock of S under the principles of §1.1502-32(c) if, immediately prior to the liquidation, such items had been taken into account under §1.1502-13(d). Therefore, B1 succeeds to 80% of the \$20 of intercompany gain from the assets distributed to B2 in the liquidation, and 80% of the \$100 of intercompany gain and 80% of the \$100 of intercompany loss from the assets that S sold prior to the liquidation. In addition, B2 succeeds to 20% of the \$20 of intercompany gain from the assets distributed to B2 in the liquidation and 20% of the \$100 of intercompany gain and 20% of the \$100 of intercompany loss from the assets that S sold prior to the liquidation.

(iii) *Taking into account intercompany items.* S's gain from its liquidating distribution to B2 and S's gain and loss from the sale of the two assets prior to the liquidation will be taken into account by B1 and B2 under the matching and acceleration rules of this section based on subsequent events. Therefore, in connection with B2 ceasing to be a member of the group, B1 will take into account \$16 of the intercompany gain from the assets distributed to B2 in the liquidation. In addition, B2 will take into account \$4 of the intercompany gain from the assets distributed to B2 in the liquidation and \$20 of the intercompany gain and \$20 of the intercompany loss from the two assets that S sold prior to the liquidation.

Example 7. Liquidation—no 80% distributee. (i) *Facts.* B1, B2, and S are members of the same consolidated group. S has only common stock outstanding. B1 and B2 each owns 40% of S's stock, and A, a nonmember, owns the remaining 20% of S's stock. On January 1 of Year 2, S sells two assets to another member of the group. S recognizes \$100 of gain with respect to the first asset and \$100 of loss with respect to the second asset. On July 1 of Year 3, S distributes all of its remaining assets to B1, B2, and A in complete liquidation. At the time of the liquidation, S's assets have an aggregate basis of \$0 and an aggregate value of \$100, and neither the gain nor the loss from the prior two asset sales has been taken into account under this section. Under §1.1502-34, section 332 applies to both B1 and B2. Under sections 336 and 337(c), S has a \$100 gain from its liquidating distributions to B1, B2, and A.

(ii) *Succession to intercompany items.* Under the matching rule, S's \$80 gain from its liquidating distributions to B1 and B2 is not taken into account under this section as a result of the liquidation (and, therefore, is not yet reflected under §§1.1502-32 and 1.1502-33). Under the successor person rule of paragraph (j)(2)(i) of this section, B1 and B2 are succes-

sors to S. Under paragraph (j)(2)(ii) of this section, B1 and B2 each succeeds to S's intercompany items to the extent that such items would have been reflected in investment basis adjustments to its stock of S under the principles of §1.1502-32(c) if, immediately prior to the liquidation, the stock of S owned by A had been redeemed in exchange for the money or property distributed to A in the liquidation, and then such items had been taken into account under §1.1502-13(d). If A had been redeemed, then S's items would have produced investment basis adjustments in the stock of S owned by each of B1 and B2 equally. Therefore, each of B1 and B2 succeeds to 50% of the \$80 of intercompany gain from the assets distributed to B1 and B2 in the liquidation and 50% of the \$100 of intercompany gain and 50% of the \$100 of intercompany loss from the assets that S sold prior to the liquidation. S's \$20 gain with respect to the assets that are distributed to A in the liquidation is taken into account immediately.

(iii) *Taking into account intercompany items.* S's gain from its liquidating distributions to B1 and B2 and S's gain and loss from the sale of the two assets prior to the liquidation will be taken into account by B1 and B2 under the matching and acceleration rules of this section based on subsequent events.

(ii) *Effective dates.* Paragraph (j)(9)(i) *Examples 6 and 7* apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Par. 3. Section 1.1502-80 is amended by:

1. Removing the second sentence from §1.1502-80(a).

2. Adding paragraph (g).

The addition reads as follows:

§1.1502-80 Applicability of other provisions of law.

* * * * *

(g) *Special rules for liquidations to which section 332 applies.* Notwithstanding the general rule of section 381, if one or more members is a distributee of assets in a liquidation to which section 332 applies and such member or members in the aggregate own stock of the liquidating corporation that satisfies the requirements of section 1504(a)(2) (regardless of whether any single member owns stock in the liquidating corporation that satisfies the requirements of section 1504(a)(2)), such member or members shall succeed to the items (including items described in section 381(c)) of the liquidating corporation, to the extent not otherwise prohibited by any applicable provision of law, as provided in this paragraph (g).

(1) Each distributee member shall succeed to the items of the liquidating corpo-

ration that could be used to offset the income or tax liability of the group or any member (including net operating loss carryovers and capital loss carryovers) to the extent that such items would have been reflected in investment basis adjustments to the stock of the liquidating corporation owned by such distributee member under the principles of §1.1502-32(c) if, immediately prior to the liquidation, any stock of the liquidating corporation owned by nonmembers had been redeemed and then such items had been taken into account. In addition, each distributee member shall succeed to the credits of the liquidating corporation (including credits under sections 38 and 53) to the extent that the items of gain, income, loss, or deduction attributable to the activities that gave rise to the credit would have been reflected in investment basis adjustments to the stock of the liquidating corporation owned by such distributee member under the principles of §1.1502-32(c) if, immediately prior to the liquidation, any stock of the liquidating corporation owned by nonmembers had been redeemed and then such items had been taken into account. If the liquidating corporation is not a member of the group at the time of the liquidation, the previous two sentences shall be applied as if the liquidating corporation had been a member of the group at the time of the liquidation. Finally, except to the extent that the distributee member's earnings and profits already reflect the liquidating corporation's earnings and profits, the earnings and profits of the liquidating corporation are allocated to each distributee member under the principles of §1.1502-32(c), treating any stock of the liquidating corporation owned by nonmembers as if it had been redeemed immediately prior to the liquidation.

(2) With regard to items to which paragraph (g)(1) of this section does not apply, a distributee member that, immediately prior to the liquidation, owns stock in the liquidating corporation meeting the requirements of section 1504(a)(2) without regard to §1.1502-34 shall succeed to items of the liquidating corporation in accordance with section 381 and other applicable principles.

(3) With regard to items to which paragraph (g)(1) of this section does not apply, a distributee member that, immediately prior to the liquidation, does not own stock in the liquidating corporation meet-

ing the requirements of section 1504(a)(2) without regard to §1.1502-34 shall succeed to items of the liquidating corporation to the extent that it would have succeeded to those items if it had purchased, in a taxable transaction, the assets or businesses of the liquidating corporation that it received in the liquidation and assumed the liabilities it assumed in the liquidation.

(4) *Examples.* The following examples illustrate the application of this paragraph (g):

Example 1. Liquidation—80% distributee. (i) *Facts.* X has only common stock outstanding. On January 1 of Year 1, X acquired equipment with a 10-year life and elected to depreciate the equipment using the straight-line method of depreciation. On January 1 of Year 7, B1 and B2 own 80% and 20%, respectively, of X's stock. X is a domestic corporation but is not a member of the group that includes B1 and B2. On that date, X distributes all of its assets to B1 and B2 in complete liquidation. The equipment is distributed to B1. Under section 334(b), B1's basis in the equipment is the same as it would be in X's hands. After computing its tax liability for the taxable year that includes the liquidation, X has net operating losses of \$100, business credits of \$40, and earnings and profits of \$80.

(ii) *Succession to items described in section 381(c).* Under paragraph (g)(1) of this section, B1 and B2 each succeeds to X's items that could be used to offset the income or tax liability of the group or any member to the extent that such items would have been reflected in investment basis adjustments to the stock of X it owned under the principles of §1.1502-32(c) if, immediately prior to the liquidation, such items had been taken into account. Accordingly, B1 and B2 succeed to \$80 and \$20, respectively, of X's net operating loss. In addition, under paragraph (g)(1) of this section, because, immediately prior to the liquidation, 80% of the items of gain, income, loss, or deduction attributable to the activities that gave rise to the business credits of \$40 would have been reflected in investment basis adjustments to the stock of X owned by B1 under the principles of

§1.1502-32(c) and 20% of those items would have been reflected in investment basis adjustments to the stock of X owned by B2 under those same principles, B1 and B2 succeed to \$32 and \$8, respectively, of X's business credits. Under paragraph (g)(1) of this section, because B1's and B2's earnings and profits do not reflect X's earnings and profits, X's earnings and profits are allocated to B1 and B2 under the principles of §1.1502-32(c). Therefore, B1 and B2 succeed to \$64 and \$16, respectively, of X's earnings and profits. Finally, because B1 owns stock in X meeting the requirements of section 1504(a)(2) without regard to §1.1502-34, under paragraph (g)(2), B1 is required to continue to depreciate the equipment using the straight-line method of depreciation.

Example 2. Liquidation—no 80% distributee. (i) *Facts.* The facts are the same as in *Example 1* except that B1 and B2 own 60% and 40%, respectively, of X's stock. Therefore, under section 334(a), B1's basis in the equipment is its fair market value at the time of the distribution. In addition, on January 1 of Year 6, X entered into a long-term contract with Y, an unrelated party. The total contract price is \$1000, and X estimates the total allocable contract costs to be \$500. At the time of the liquidation, X had received \$250 in progress payments under the contract and incurred costs of \$125. X accounted for the contract under the percentage of completion method described in section 460(b). In the liquidation, B1 assumes X's contract obligations and rights.

(ii) *Succession to items described in section 381(c).* (A) *Losses and credits.* Under paragraph (g)(1) of this section, B1 and B2 each succeeds to X's items that could be used to offset the income or tax liability of the group or any member to the extent that such items would have been reflected in investment basis adjustments to the stock of X it owned under the principles of §1.1502-32(c) if, immediately prior to the liquidation, such items had been taken into account. Accordingly, B1 and B2 succeed to \$60 and \$40, respectively, of X's net operating loss. In addition, under paragraph (g)(1) of this section, because, immediately prior to the liquidation 60% of the items of gain, income, loss, or deduction attributable to the activities that gave rise to the business credits of \$40 would have been reflected in investment basis adjustments to the stock of X owned by B1 under the

principles of §1.1502-32(c) and 40% of those items would have been reflected in the investment basis adjustments to the stock of X owned by B2 under those same principles, B1 and B2 succeed to \$24 and \$16, respectively, of X's business credits.

(B) *Earnings and profits.* Under paragraph (g)(1) of this section, because B1's and B2's earnings and profits do not reflect X's earnings and profits, X's earnings and profits are allocated to B1 and B2 under the principles of §1.1502-32(c). Therefore, B1 and B2 succeed to \$48 and \$32, respectively, of X's earnings and profits.

(C) *Depreciation of equipment's basis.* By reason of section 168(i)(7), to the extent that B1's basis in the equipment does not exceed X's basis in the equipment, B1 will be required to continue to depreciate the equipment using the straight-line method of depreciation.

(D) *Method of accounting for long-term contract.* Under paragraph (g)(3) of this section, B1 does not succeed to X's method of accounting for the contract. Rather, under §1.460-4(k)(2), B1 is treated as having entered into a new contract on the date of the liquidation. Under §1.460-4(k)(2)(iii), B1 must evaluate whether the new contract should be classified as a long-term contract within the meaning of §1.460-1(b) and account for the contract under a permissible method of accounting.

(5) *Effective date.* Paragraph (g) applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

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

(Filed by the Office of the Federal Register on February 18, 2005, 8:45 a.m., and published in the issue of the Federal Register for February 22, 2005, 70 F.R. 8552)

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

Announcement 2005-15

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

person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility, will announce in the Internal Revenue Bulletin

their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Consent Disbarments From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid institution or conclusion of a proceeding for his or her disbarment or suspension from practice be-

fore the Internal Revenue Service, may offer his or her consent to disbarment from such practice. The Director, Office of Professional Responsibility, in his discretion, may disbar an attorney, certified public ac-

countant, enrolled agent or enrolled actuary in accordance with the consent offered.

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

Name	Address	Designation	Date of Disbarment
O'Connell, Anthony G.	Revere, MA	CPA	Indefinite from January 5, 2005

Suspensions From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an ad-

ministrative law judge, the following individuals have been placed under suspension

from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
McCarthy III, William P.	Sacramento, CA	Enrolled Agent	September 12, 2004 to March 10, 2006
Deen, Mae T.	Salinas, CA	Enrolled Agent	October 18, 2004 to April 16, 2006
Adams Jr., Joseph T.	Philadelphia, PA	Enrolled Agent	December 1, 2004 to May 29, 2006

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid institution or conclusion of a proceeding for his or her disbarment or suspension from practice be-

fore the Internal Revenue Service, may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public

accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

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

Name	Address	Designation	Date of Suspension
Cornelius, Gerald K.	Ventura, CA	Enrolled Agent	Indefinite from September 15, 2004
Janus, Stephen E.	Michigan City, IN	CPA	Indefinite from October 25, 2004
Arotsky, Marvin A.	New Haven, CT	CPA	Indefinite from December 1, 2004
Penta, Richard	Hamilton, MA	CPA	Indefinite from January 1, 2005

Name	Address	Designation	Date of Suspension
Bedell, Michael F.	Ridge, NY	CPA	Indefinite from January 7, 2005
Nussbaum, Jerrold	Annapolis, MD	Attorney	Indefinite from April 15, 2005

Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date

the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions:

Name	Address	Designation	Date of Suspension
Whitworth, Douglas D.	Houston, TX	CPA	Indefinite from October 28, 2004
Lindberg, William D.	Costa Mesa, CA	CPA	Indefinite from November 4, 2004
Tompkins, Thomas M.	Chickasaw, AL	Attorney	Indefinite from November 4, 2004
Peterson Jr., Theodore E	Charlotte, NC	CPA	Indefinite from November 4, 2004
Gassiott, William E.	Cypress, TX	CPA	Indefinite from November 4, 2004
Wagar Jr., John E.	Lafayette, LA	Attorney	Indefinite from November 9, 2004
Fiore, Owen G.	Kooskia, ID	Attorney	Indefinite from November 30, 2004
O'Keefe, Michael H.	Beaumont, TX	Attorney	Indefinite from November 30, 2004
Ivker, Richard N.	Waltham, MA	Attorney	Indefinite from November 30, 2004

Name	Address	Designation	Date of Suspension
Jones, Edwin A.	Robards, KY	Attorney	Indefinite from November 30, 2004
Landis, John C.	Drexel Hill, PA	Attorney	Indefinite from November 30, 2004
Cushman, Christopher A.	Kansas City, MO	Attorney	Indefinite from November 30, 2004
Weiner, Alan S.	Rockville, MD	Attorney	Indefinite from November 30, 2004
Virdone, Peter P.	Kailua, HI	CPA	Indefinite from November 30, 2004
Doherty, Paul M.	N. Billerica, MA	Attorney	Indefinite from December 3, 2004
Carney, Kevin F.	Woburn, MA	Attorney	Indefinite from December 3, 2004
Greiner, Thomas	Cleveland, OH	Attorney	Indefinite from December 8, 2004
Wertis, Richard L.	Garden City, NY	Attorney	Indefinite from December 10, 2004
Southerland, Harry L.	Raeford, NC	Attorney	Indefinite from December 10, 2004
Chestnutt, A. Johnson	Fayetteville, NC	CPA	Indefinite from December 13, 2004
Heald, Arthur A.	Saint Albans, VT	Attorney	Indefinite from December 10, 2004
Culliton, James M.	Santa Clarita, CA	Attorney	Indefinite from December 15, 2004
Juarez, Michael G.	Douglas, AZ	Attorney	Indefinite from December 15, 2004
Clark, Carroll A.	Mesa, AZ	Attorney	Indefinite from December 15, 2004

Name	Address	Designation	Date of Suspension
Creque, George A	Willow Springs, CA	Attorney	Indefinite from December 15, 2004
Younts, Roger W.	Lexington, NC	CPA	Indefinite from December 15, 2004
Kluge, David R.	Sheridan, OR	Attorney	Indefinite from December 15, 2004
Fanaras, Andrew R.	Haverhill, MA	Attorney	Indefinite from December 15, 2004
Murphy, Patrick B.	Alhambra, CA	Attorney	Indefinite from December 20, 2004
Mills, Stuart B.	Pender, NE	Attorney	Indefinite from December 20, 2004
North, Gerald D.W.	Chicago, IL	Attorney	Indefinite from December 20, 2004
Nickel, Warren J.	Tinley Park, IL	Attorney	Indefinite from December 20, 2004
Gray, Douglas C.	Dover, NH	Attorney	Indefinite from December 20, 2004
Emmons, Kyle D.	Columbia, MO	Attorney	Indefinite from December 20, 2004
Velella, Guy J.	Bronx, NY	Attorney	Indefinite from December 30, 2004
Ginn, Jeffrey S.	Lexington, KY	CPA	Indefinite from January 25, 2005
Grenrod Jr., Bernard	West Monroe, LA	Attorney	Indefinite from January 25, 2005
Tehin Jr., Nikolai	San Francisco, CA	Attorney	Indefinite from January 25, 2005
Kemper, Morris B.	Alameda, CA	Attorney	Indefinite from January 25, 2005
Harrison, John S.	Oakland, CA	Attorney	Indefinite from January 25, 2005

Name	Address	Designation	Date of Suspension
Mangurten, Irvin B.	Buffalo Grove, IL	CPA	Indefinite from January 27, 2005
Zivin, Mitchell W.	Long Grove, IL	Attorney	Indefinite from February 7, 2005
Zdon, John N.	Chicago, IL	Attorney	Indefinite from February 7, 2005
Lokietz, David S.	Mount Dora, FL	CPA	Indefinite from February 7, 2005
Heldrich Jr., Gerard C.	Lincolnshire, IL	Attorney	Indefinite from February 7, 2005
Whitaker, Paul M.	Albany, NY	Attorney	Indefinite from February 18, 2005
Blake, Linda D.	Bellvale, NY	Attorney	Indefinite from February 18, 2005
Smith, H. Paul	San Antonio, TX	Attorney	Indefinite from February 18, 2005
Atwood, Adina A.	Ardmore, OK	Attorney	Indefinite from February 18, 2005
Sablone Jr., Francis R.	Old Lyme, CT	Attorney	Indefinite from February 18, 2005
Phelps, S. Don	Olympia, WA	Attorney	Indefinite from February 18, 2005
Davidson, Frazier	Bronx, NY	Attorney	Indefinite from February 18, 2005

Censure Issued by Consent

Under Title 31, Code of Federal Regulations, Part 10, in lieu of a proceeding being instituted or continued, an attorney, certified public accountant, enrolled agent,

or enrolled actuary, may offer his or her consent to the issuance of a censure. Censure is a public reprimand.

The following individuals have consented to the issuance of a Censure:

Name	Address	Designation	Date of Censure
Dorris, Virginia A.	Bradenton, FL	Enrolled Agent	December 14, 2004
Mackey, Glen N.	Roanoke, VA	Attorney	December 21, 2004

Executive Stock Options Settlement Initiative

Announcement 2005–19

Section 1. Purpose of the Initiative

The Internal Revenue Service announces an initiative to resolve transactions that are the same as or substantially similar to those described in Notice 2003–47, 2003–2 C.B. 132. Taxpayers have until May 23, 2005, to notify the Service of their intent to participate in this settlement initiative.

The Service identified this transaction as a listed transaction in Notice 2003–47 and believes it will prevail in litigation both on the merits and in imposing penalties. The Service has decided, however, that for efficient tax administration reasons it will offer affected parties an opportunity to resolve quickly their tax issues and avoid protracted and costly litigation through the execution of a closing agreement pursuant to this announcement.

Section 2. The Parties and Eligibility Requirements

A typical Notice 2003–47 transaction (Transaction) involves an officer, director or employee (Executive) to whom a

compensatory non-statutory stock option or restricted stock¹ is granted in connection with the performance of services for a corporation (Corporation). The Executive transfers the stock option to an entity (Related Person), which is typically a limited partnership substantially owned by the Executive and immediate family members. The Related Person typically pays for the stock option by giving the Executive a deferred payment obligation such as a long-term, unsecured note with principal payments deferred until maturity, or an annuity.

This initiative is open to (1) the Executive and the Related Person and (2) the Corporation, if:

- The Executive transferred the option to the Related Person before July 2, 2003; and
- The person electing to participate is not a party in a court proceeding to determine the tax treatment of the Transaction.²

The Corporation may participate in this settlement initiative without the Executive or Related Party and the Executive may participate without the Corporation. However, the Executive must participate with the Related Person.³

Section 3. Settlement Terms for Participating Parties

a. For the Executive and the Related Person, except as provided in Section 3(c)(1), the terms of the closing agreement entered into pursuant to this announcement must include the following —

1. Compensation Income. The Executive must recognize total compensation income equal to the fair market value of the stock covered by the stock option measured at the exercise date (or vesting date for restricted stock), less any amounts paid for (i) the stock on exercise of the option (the exercise price) by the Related Person, and (ii) the option by the Executive. The Executive must recognize the compensation income in the taxable year that the Related Person disposed of the stock or, if not yet disposed of, in the taxable year that includes December 31, 2004. However, if in an earlier taxable year the Executive received payments on the deferred payment obligation, or received payments of cash or property other than a deferred payment obligation as consideration for the option, the Executive must recognize the payments (other than amounts recognized under Sections 3(a)(3) and 3(a)(4)), as compensation in the taxable year(s) the payments are received.

2. Gain Recognition. The Executive must recognize gain if the amount paid by

¹ The term “restricted stock” refers to a grant to an Executive of stock that is not substantially vested at the time of grant, as defined in Treas. Reg. § 1.83–3(b). Unless otherwise noted, references to stock options also include restricted stock.

² For an electing Executive, neither the Executive nor the Related Person may be a party to such a court proceeding. This exception also applies to a person who is a party to a court proceeding in that person’s capacity as partner in an entity subject to the unified partnership audit and litigation provisions of §§ 6221 through 6234, as enacted by the Tax Equity and Fiscal Responsibility Act of 1982.

³ If the Related Person is a pass-through entity, all members of the pass-through entity must agree to participate in the settlement initiative.

the Related Person for the option (that is, the amount of the deferred payment obligation⁴ and any cash or property other than a deferred payment obligation) exceeds the amount recognized as compensation income under Section 3(a)(1). Gain not yet recognized and attributable to (i) the deferred payment obligation that would be recognized on receipt of the deferred payment obligation under the relevant provisions of the Internal Revenue Code and Income Tax Regulations and (ii) cash or property other than a deferred payment obligation, must be recognized in the taxable year that the Related Person disposed of the stock or, if not yet disposed of, in the taxable year that includes December 31, 2004. The Executive may not recognize any loss.

3. Interest on Deferred Payments. The Executive must recognize interest income on the deferred payment obligation when the interest is paid or accrued, whichever is applicable under the relevant provisions of the Code and regulations for interest (for example, § 1272). The Related Person may be entitled to an interest expense deduction as determined under § 163 and other applicable Code provisions.

4. Annuities. Section 72 governs annuity payments received by the Executive. For purposes of calculating the excludable amount, the amount of compensation determined under Section 3(a)(1), plus any gain attributable to the annuity that has been recognized by the Executive at the time the closing agreement is executed, is treated as the investment in the contract. The portion of each annuity payment not excluded must be included in the Executive's income.

5. Transaction Costs. The Service will not challenge the capitalization, deduction, or amortization of costs paid by the Executive or Related Person to investigate, pursue, and, consummate the Transaction, including promoter fees and fees for accounting, appraisal, and legal services (Transaction Costs). To the extent the Executive or Related Person that paid those costs has not claimed a deduction on a previously filed U.S. federal income tax return for those Transaction Costs, that person may claim the deduction in the tax-

able year that includes the taxable year in which the Executive recognizes the compensation income under Section 3(a)(1).

6. Federal Insurance Contributions Act (FICA) Tax. The Executive must pay the employee's share of FICA tax on the compensation income recognized under Section 3(a)(1) in accordance with the timing rules under Section 3(a)(1).

7. Penalty. The Executive must pay an accuracy related penalty under § 6662 equal to ten percent of the amount of any underpayment (as defined in § 1.6664-2(a) of the Income Tax Regulations) attributable to the Transaction unless the Executive filed a valid disclosure under Announcement 2002-2, 2002-1 C.B. 304. For the taxable year that includes December 31, 2004, the amount of the underpayment attributable to the Transaction is equal to the increased tax resulting from the income recognized under Sections 3(a)(1) and (2) (as applicable) in that taxable year. An Executive that filed a qualified amended return is eligible to participate in this settlement initiative.

8. Related Person's Stock Basis. The Related Person's basis in the stock is equal to the sum of (i) the income and gain recognized under Sections 3(a)(1) and (2), (ii) the exercise price paid for the stock, and (iii) the amount, if any, paid for the option or restricted stock by the Executive. The acquisition date is deemed to be the date on which the option was exercised.

b. For the Corporation, except as provided in Section 3(c)(2), the terms of the closing agreement entered into pursuant to this announcement must include the following —

1. Compensation Deduction. The Corporation may claim a compensation deduction (if otherwise allowable in the year of transfer, exercise, or vesting) no greater than the total compensation determined under Section 3(a)(1). To the extent the corporation has not already claimed the compensation deduction, it may claim the deduction in a taxable year that includes any of the following: (i) the date the Executive transferred the stock option to the Related Person; (ii) the date the option was exercised (or the stock vested);

(iii) December 31 of the year in which the Executive recognized the compensation; or (iv) December 31, 2004.

2. FICA Tax. The Corporation must pay the employer's share of FICA tax on the compensation income determined under Section 3(a)(1) for the calendar year ending during the taxable year in which the Corporation claims the deduction under Section 3(b)(1). In addition, for the same taxable year, the Corporation must pay the employee's share of FICA tax for each Executive that participated in a Transaction but does not settle under this settlement initiative (Non-participating Executive). The payment of both the employer's and employee's shares of FICA tax is made without interest. In addition, the Corporation must issue a Form W-2c, *Corrected Wage and Tax Statement*, as specified in the closing agreement.

3. Transaction Costs. The Service will not challenge the capitalization, deduction, or amortization of Transaction Costs paid by the Corporation to investigate, pursue, and consummate the Transaction. To the extent the Corporation has not claimed a deduction on a previously filed U.S. federal income tax return for those Transaction Costs paid by the Corporation, it may claim the deduction in the same taxable year in which the compensation deduction is claimed under Section 3(b)(1).

4. Penalties. No penalties will be imposed on the Corporation for its participation in the Transaction.

5. Withholding for Supplemental Wages. If the Corporation participates in this settlement initiative and one or more of its Executives do not, then for each Non-participating Executive, the Corporation must satisfy its withholding liability by paying an amount equal to the applicable flat supplemental withholding rate times the Executive's compensation income as determined under Section 3(a)(1) for the taxable year in which the Corporation claims the deduction under Section 3(b)(1). The payment is made without interest; however, the Corporation must issue a Form W-2c as specified in the closing agreement.

c. Special Terms Where Option Not Exercised. If the stock option has not

⁴ For example, if the deferred payment obligation is a note, the amount of the note would be the stated principal amount of the note received if the note provides for interest at a rate at least equal to the applicable Federal rate. For purposes of this initiative, the amount of an annuity is the present value of the annuity determined on the transfer date using the same actuarial assumptions and interest rate used to formulate the annuity if such assumptions were reasonable; otherwise the valuation must be determined using reasonable actuarial assumptions and interest rate.

been exercised or the restricted stock has not vested by February 22, 2005, the terms of the closing agreement entered into pursuant to this announcement must include the following —

1. For the Executive and Related Person—

i. In the year the option is exercised or the restricted stock vests, the Executive must recognize total compensation income as determined under Section 3(a)(1). Gain must be recognized in accordance with Section 3(a)(2), except that the taxable year the option is exercised or the restricted stock vests is substituted for the taxable year that the Related Person disposed of the stock or, if not yet disposed of, the taxable year that includes December 31, 2004. Interest on the deferred payment obligation must be included in income as described in Section 3(a)(3). Annuity payments must be included in income as described in Section 3(a)(4). All other payments made on the deferred payment obligation before exercise (or vesting) must be recognized as compensation income in the years in which the payments are received. If the Executive received cash or property other than the deferred payment obligation before February 22, 2005, the Executive must recognize compensation income in the year received.

ii. The Executive must pay the employee's share of FICA tax on the compensation determined under Section 3(a)(1) in the same taxable year(s) the compensation income is recognized under Section 3(c)(1)(i).

iii. The Executive or Related Person may deduct the Transaction Costs paid by the Executive or Related Person (as appropriate) but only in the year the Executive recognizes income under Section 3(c)(1)(i) and only to the extent of compensation income recognized by the Executive up to and including that year. The Executive or the Related Person (as appropriate) must include in income for the taxable year that includes December 31, 2004, any Transaction Costs deducted or amortized in years before February 22, 2005, including amounts claimed in a year barred by the period of limitations on assessments.

iv. Unless the Executive filed a valid disclosure under Announcement 2002–2,

the Executive must pay an accuracy-related penalty of ten percent on the underpayment attributable to the Transaction in the taxable year(s) determined under Section 3(c)(1)(i). For the taxable year(s) determined under Section 3(c)(1)(i), the amount of the underpayment attributable to the Transaction is equal to the increased tax resulting from the income recognized under Sections 3(a)(1) and (2).

v. The Related Person is entitled to basis in the stock (or the option before exercise) equal to the sum of (i) the income and gain recognized under Sections 3(a)(1) and (2), (ii) the exercise price paid for the stock when the option is exercised, and (iii) the amount, if any paid, for the option or restricted stock by the Executive.

2. For the Corporation—

i. The Corporation may claim a deduction (if otherwise allowable in the year of transfer, exercise, or vesting) for the compensation income as determined under Section 3(a)(1) for the taxable year that includes the taxable year(s) in which the Executive would recognize the compensation income under Section 3(c)(1)(i).

ii. The Corporation may deduct the Transaction Costs paid by the Corporation as described in Section 3(b)(3) in the taxable year the Corporation claims the compensation deduction under Section 3(c)(2)(i).

iii. The Corporation must pay the employer's share of FICA tax on the compensation income determined under Section 3(a)(1) for the calendar year ending during the taxable year in which the Corporation claims the compensation deduction under Section 3(c)(2)(i). In addition, for the same taxable year, the Corporation must pay the employee's share of the FICA tax for each Non-participating Executive.

iv. If the Corporation participates in this settlement initiative and one or more of its Executives do not, then for each Non-participating Executive, the Corporation must satisfy its income tax withholding liability by paying an amount equal to the applicable flat supplemental withholding rate (including the mandatory 35 percent rate for supplemental wages in excess of \$1,000,000) times the Executive's compensation income as determined under Section 3(a)(1) for the taxable year in

which the Corporation claims the deduction under Section 3(c)(2)(i).

d. Corporation Must Participate for All of its Executives. The closing agreement must apply with respect to all of the officers, directors, and employees of the Corporation that participated in the Transaction with respect to which there was a transfer of the stock option before July 2, 2003.

e. Estate and Gift Taxes. Execution of a closing agreement under this settlement initiative does not affect the application of gift, estate and generation-skipping transfer taxes which may result from the Transactions covered by this settlement initiative.

f. Related Person. Execution of a closing agreement under this settlement initiative does not preclude the Service from pursuing with the Executive or the Related Person (and its members) additional adjustments related to the activities of the Related Person (other than as specified in Section 3(a)(8)).

g. Other Matters. Execution of a closing agreement under this settlement initiative does not preclude the Service from investigating any associated criminal conduct or recommending prosecution for violation of any criminal statute.

Section 4. Procedures for Closing Cases

a. Notice of Election. To notify the Service of their intent to participate in this settlement initiative, persons must send the Notice of Election (Form 13656 for Executives and Related Persons and Form 13657 for Corporations) on or before May 23, 2005. The Service will not extend the time period for submitting the Notice of Election. If the Related Person is a pass-through entity, each member of the entity must sign the election.

The Notice of Election should be sent by certified mail or designated delivery service (within the meaning of § 7502(f)) and must be sent to:

INTERNAL REVENUE SERVICE
Attn: Announcement 2005–19
MC 4166 NWSAT
4050 Alpha Rd.
Farmers Branch, TX 75244

Persons under examination or in Appeals also should provide a copy of the No-

tice of Election to the examining agent or Appeals Officer.

The Notice of Election must be signed under penalties of perjury. Further, the Corporation must disclose the identity (including taxpayer identification numbers) of all its current and former Executives that participated in the Transactions, and the Executive must disclose the Corporation's identity.

If the Corporation filed a consolidated federal income tax return for any taxable period affected by the terms of the settlement, then the parent of the affiliated group and each subsidiary that participated in the Transaction must file a separate Notice of Election.

The Notice of Election requests information necessary to process the election and determine the proper tax liabilities. Additional information may be requested after the Notice of Election is submitted. The Service can decline to execute a closing agreement with any person that fails to provide requested information.

b. Closing Agreement and Payment.

After receiving all of the necessary information, the Service will prepare a closing agreement under § 7121 reflecting the terms of the settlement. The Service will send the closing agreement to the taxpayer, who must sign and return it to the Service within 30 days of the date of mailing by the Service. The Service may grant an extension for good cause.

Taxpayers must either submit payment in full of all taxes, interest, and penalties due under the terms of the settlement when they return the signed closing agreement to the Service, or make other financial arrangements as described below. If a person does not know the amount of the underpayment for the taxable year containing December 31, 2004, that person must make an estimated payment using the maximum applicable marginal rate. If the estimated payment exceeds the actual underpayment determined after the filing of that person's U.S. federal income tax return for the taxable year containing December 31, 2004, the person may request a refund for the excess. Any person not making full payment must submit complete financial statements and agree to other financial arrangements acceptable to the Service before the Service will execute a closing agreement. The Service will not execute a closing agree-

ment with anyone unable to reach acceptable financial arrangements.

Directors, Field Operations (Large & Mid-Size Business) are authorized to execute closing agreements prepared under this settlement initiative, including agreements for taxable periods ending after the date on which the agreement is executed, on behalf of the Service. This authority may not be redelegated.

Section 5. Non-Participants' Dispute Resolution Procedures

a. Case Development. The Service has examined numerous Transactions, which, except for minor factual variations, follow a common template. The Service has determined that notwithstanding the factual differences, these Transactions should be treated similarly for purposes of this settlement initiative and do not warrant terms more favorable than this settlement initiative. The Service will develop all of the potential issues, make appropriate income and expense adjustments for all tax benefits and attributes claimed, and determine appropriate income and employment tax penalties for Executives, Related Persons, and Corporations that do not participate in this settlement initiative (non-participants).

b. Appeals Consideration. Non-participants may request Appeals review of disputed tax and penalty determinations. Appeals has independently considered the issues raised by these Transactions with respect to Executives (and the Related Persons), and has evaluated the potential litigation hazards. Appeals has concluded that Executives and Related Persons should not expect a resolution of either the tax or penalty issues on terms that are more favorable than the terms offered in this settlement initiative. In addition, the resolution of a taxpayer's case in Appeals will be based on the merits of the issues presented and will not involve administrative terms, such as the deferral of the recognition of income by the Executive. Consequently, a resolution of a Transaction with Appeals may be less favorable than the terms of this settlement initiative.

Appeals has not reviewed the corporate income tax, employment tax or penalty issues raised by these Transactions with respect to any Corporation. These include:

(1) withholding for supplemental wages, (2) employer's and employee's FICA taxes, (3) failure to deposit penalties, (4) accuracy-related penalties on failure to pay income tax withholding or FICA tax, (5) disallowance of deduction for Transaction Costs paid on behalf of the Executive and associated accuracy-related penalties, (6) information reporting penalty for furnishing incorrect W-2s, and (7) disallowance of deduction for stock option compensation income. Independent Appeals' consideration will be available for Corporations not taking part in this settlement initiative with respect to disputed tax and penalty issues following full development of these issues by the Service.

Section 6. Paperwork Reduction Act

The collection of information in this announcement has been reviewed and approved by the Office of Management and Budget under the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545-1929. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless collecting information displays a valid OMB number.

The collection of information in this announcement is in Section 4, Procedures for Closing Cases. This information is required to apply the terms of the settlement and determine the suitable amount of any penalties. Collecting information is required to obtain the benefit described in this announcement. The likely respondents are individuals and businesses or other for-profit institutions.

The estimated total annual reporting burden is 875 hours.

The estimated annual burden per respondent varies from 3 to 7 hours, depending on individual circumstances, with an estimated average of 5 hours. The estimated number of respondents is 175.

The estimated frequency of responses is one time per respondent.

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

Section 7. Contact Information

The principal authors of this announcement are Stephen Tackney of the Office of Division Counsel/Associate Chief Coun-

sel (Tax Exempt and Government Entities) and Rebecca E. Asta of the Office of Chief Counsel. However, other personnel from the Treasury Department and the Service participated in its development. For

information about this announcement, contact Walter Harris, Deputy Director, Field Specialists LMSB Division, at (202) 283-8290 (not a toll-free number).

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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