Internal Revenue
bulletin

Bulletin No. 2006-37
September 11, 2006

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. 2006–45, page 423.

Mutual life insurance companies; recomputed differential earnings rate. The recomputed differential earnings rate for 2004 is determined for use by mutual life insurance companies to compute their income tax liability for 2005.

T.D. 9273, page 394.

Final regulations under section 367 of the Code provide guidance with respect to the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in a foreign-to-foreign or inbound corporate reorganization or liquidation described in both section 367(b) and section 381.

Announcement 2006–62, page 444.

The 2006 Form 8830, *Enhanced Oil Recovery Credit,* will not be issued for the 2007 processing year since the credit is completely phased out for 2006 due to the increased applicable reference price of crude oil.

Announcement 2006–63, page 445.

This announcement describes the limited role of private collection agencies (PCAs) in the collection of federal taxes. The announcement includes descriptions of the legal restrictions and administrative procedures in place to ensure PCAs respect taxpayer rights and protections. The announcement also describes what a taxpayer can expect if the IRS assigns the taxpayer's account to a PCA for collection activity.

EXEMPT ORGANIZATIONS

Announcement 2006–69, page 449.

The IRS has revoked its determination that Youth Ministries, Inc., d/b/a Operation Rescue West, of Wichita, KS, no longer qualifies as an organization described in sections 501(c)(3) and 170(c)(2) of the Code.

EMPLOYMENT TAX

T.D. 9276, page 423.

Final regulations under section 3402 of the Code concern the definition of supplemental wages for income tax withholding purposes and income tax withholding requirements for employers making payments of supplemental wages to employees.

ADMINISTRATIVE

Rev. Proc. 2006–35, page 434.

This revenue procedure announces new user fees that will be charged by the Service to process Form 8802, *Application for United States Residency Certification*. The user fee will be charged for all Form 8802 applications submitted with a postmark date on or after October 2, 2006. The rules for these user fees are set forth and will be incorporated in the next revision of Form 8802 and accompanying instructions.

(Continued on the next page)

Announcements of Disbarments and Suspensions begin on page 436.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Announcement 2006–63, page 445.
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Announcement 2006–64, page 447.
This document contains corrections to proposed regulations (REG–135866–02, 2006–27 I.R.B. 34) that provide guidance for determining the earnings and profits attributable to stock of controlled foreign corporations (or former controlled foreign corporations) that are (were) involved in certain nonrecognition transactions.

Announcement 2006–65, page 447.
This document contains additional corrections to proposed regulations (REG–135866–02, 2006–27 I.R.B. 34) that provide guidance for determining the earnings and profits attributable to stock of controlled foreign corporations (or former controlled foreign corporations) that are (were) involved in certain nonrecognition transactions.

Announcement 2006–66, page 448.
This document contains corrections to final regulations (T.D. 9254, 2006–13 I.R.B. 662) that apply when a member of a consolidated group transfers subsidiary stock at a loss. They also apply when a member holds loss shares of subsidiary stock and the subsidiary ceases to be a member of the group.

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 367.—Foreign Corporations

26 CFR 1.367(b)–7: Carrryover of earnings and profits and foreign income taxes in certain foreign-to-foreign nonrecognition transactions.

T.D. 9273

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Stock Transfer Rules: Carryover of Earnings and Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations addressing the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in a corporate reorganization or liquidation that is described in both section 367(b) and section 381 of the Internal Revenue Code (Code).

DATES: *Effective Date:* These regulations are effective August 8, 2006.

Applicability Date: These regulations apply to certain section 367(b) exchanges that occur on or after November 6, 2006.

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry at (202) 622–3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The Treasury Department and the IRS issued final regulations §§1.367(b)–1 through 1.367(b)–6, dealing with tax consequences of certain foreign-to-foreign and inbound corporate transactions, in June 1998 and January 2000 (the January 2000 final regulations). The preamble to the January 2000 final regulations referred to proposed regulations that would be issued to address the carryover of certain corporate tax attributes in transactions involving one or more foreign corporations. Those proposed regulations were issued on November 15, 2000, in the **Federal Register** ((65 FR 69138) (REG–116050–99, 2000–2 C.B. 520)) (the 2000 proposed regulations). The public hearing with respect to the 2000 proposed regulations was cancelled because no request to speak was received. However, the Treasury Department and the IRS received and considered several written comments, which are discussed in this preamble.

After consideration of the 2000 proposed regulations and the comments received, the Treasury Department and the IRS adopt substantial portions of those proposed regulations with significant modifications as final regulations under section 367(b).

Overview

A. General Policies of Section 367(b)

In general, section 367 governs corporate restructurings under sections 332, 351, 354, 355, 356, and 361 (Subchapter C nonrecognition transactions) in which the status of a foreign corporation as a "corporation" is necessary for the application of the relevant Subchapter C nonrecognition provisions. Other provisions in Subchapter C (Subchapter C carryover provisions) apply to such transactions in conjunction with the enumerated provisions and detail additional consequences that occur in connection with the transactions. For example, sections 362 and 381 govern the carryover of basis and earnings and profits from the transferor corporation to the transferee corporation in applicable transactions.

The Subchapter C carryover provisions generally are drafted to apply to domestic corporations and U.S. shareholders. As a result, those provisions often do not fully take into account the relevant cross-border aspects of U.S. taxation. For example, section 381 does not specifically take into account source and foreign tax credit issues that arise when earnings and profits move from one corporation to another.

Congress enacted section 367(b) to ensure that international tax considerations in the Code are adequately addressed when the Subchapter C provisions apply to an exchange involving a foreign corporation. A primary consideration in this regard is to prevent the avoidance of U.S. taxation. Because determining the proper interaction of the Code's international and Subchapter C provisions is "necessarily highly technical," Congress granted the Secretary broad regulatory authority to provide the "necessary or appropriate" rules rather than enacting a more comprehensive statutory regime. H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975). Thus, section 367(b)(2) provides in part that the regulations "shall include (but shall not be limited to) regulations * * * providing * * * the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets."

These final regulations address the carryover of foreign earnings and profits and foreign income taxes in tax-free corporate asset acquisitions by generally applying the principles of Subchapter C provisions such as section 381, which governs the carryover of earnings and profits (and other tax attributes) in certain tax-free corporate reorganizations described in section 368 and in corporate liquidations described in section 332. However, these regulations (like the 2000 proposed regulations) modify certain of the mechanics of the Subchapter C rules as necessary or appropriate to ensure that those rules are as consistent as possible with key international tax policies of the Code and to prevent material distortions of income.

These final regulations address the portions of the 2000 proposed regulations (Prop. Reg.) dealing with inbound nonrecognition transactions (Prop. Reg. §1.367(b)–3) and foreign section 381 transactions (Prop. Reg. §1.367(b)–7). They also address the special rules of Prop. Reg. §1.367–9. The final regulations, however, do not address the portions of the 2000 proposed regulations involving corporate divisions of one or more foreign corporations (Prop. Reg. §1.367(b)–8). The Treasury Department and the IRS believe that relevant cross-border tax consequences of section 355 transactions should be dealt with in a separate guidance project.

B. Specific Policies Related to Inbound Nonrecognition Transactions (§1.367(b)–3)

Section 1.367(b)–3 addresses acquisitions by a domestic corporation (domestic acquiring corporation) of the assets of a foreign corporation (foreign acquired corporation) in a section 332 liquidation or an asset acquisition described in section 368(a)(1), such as an A, C, D, or F reorganization (inbound nonrecognition transaction). Regulations applying section 367 and section 368 to cross-border A reorganizations were recently issued. See T.D. 9242, 2006–7 I.R.B. 422.

As a general policy matter, the importation of various tax attributes in inbound transactions is carefully scrutinized. In fact, inbound importation issues have been the subject of recent legislative reforms (see section 362(e)). The policy relating to importation of tax attributes also has been reflected in prior section 367 regulations. For example, the preamble to the January 2000 final regulations generally describes international policy issues that can arise in inbound nonrecognition transactions. The preamble states that the "principal policy consideration of section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic corporations. This consideration has interrelated shareholder-level and corporate-level components." The January 2000 final regulations clarify that a domestic acquiring corporation succeeds to those foreign taxes paid or accrued by a foreign target corporation only to the extent those taxes are eligible for credit under section 906.

The preamble to the January 2000 final regulations also notes that it would be consistent with the policy considerations of section 367(b) for future regulations to provide additional rules with respect to the extent to which attributes carry over from a foreign corporation to a U.S. corporation. Accordingly, the 2000 proposed regulations provided rules concerning several attributes, specifically net operating loss and capital loss carryovers, and earnings and profits that are not included in income as an all earnings and profits amount (or a deficit in earnings and profits). The 2000 proposed regulations generally provided that these tax attributes carry over from a foreign acquired corporation to a domestic acquiring corporation only to the extent that they are effectively connected with a U.S. trade or business (or attributable to a permanent establishment, in the case of an applicable U.S. income tax treaty). These final regulations adopt the rules set forth in the 2000 proposed regulations.

C. Specific Policies Related to Foreign Section 381 Transactions (§1.367(b)–7)

Section 1.367(b)–7 applies to an acquisition by a foreign corporation (foreign acquiring corporation) of the assets of another foreign corporation (foreign target corporation) in a transaction described in section 381 (foreign section 381 transaction) and addresses the manner in which earnings and profits and foreign income taxes of the foreign acquiring corporation and foreign target corporation carry over to the surviving foreign corporation (foreign surviving corporation). These rules apply, for example, to A, C, D, or F reorganizations or section 332 liquidations between two foreign corporations.

The principal Code sections implicated by the carryover of earnings and profits and foreign income taxes in a foreign section 381 transaction are sections 381, 902, 904, and 959. Section 381 generally permits earnings and profits (or deficit in earnings and profits) to carry over to a surviving corporation, thus enabling "the successor corporation to step into the 'tax shoes' of its predecessor. * * * [and] represents the economic integration of two or more separate businesses into a unified business enterprise." H. Rep. No. 1337, 83rd Cong., 2nd Sess. 41 (1954). However, a deficit in earnings and profits of either the transferee or transferor corporation can only be used to offset earnings and profits accumulated after the date of transfer. Section 381(c)(2)(B). This is commonly known as the "hovering deficit rule". The hovering deficit rule is a legislative mechanism designed to deter the trafficking in favorable tax attributes that the IRS and courts had repeatedly encountered. See, for example, *Commissioner v. Phipps*, 336 U.S. 410 (1949). These final regulations generally adopt the principles of section 381 in the cross-border context, but adapt the operation of those rules in consideration of the international provisions, such as sections 902, 904, and 959, that address foreign corporations' earnings and profits and their related foreign income taxes. Thus, for example, these final regulations apply the section 381 earnings and profits combination and deficit rules by reference to the separate categories of income described in section 904(d) and elsewhere (baskets) that are used to compute foreign tax credit limitations.

Section 902 generally provides that a deemed paid foreign tax credit is available to a domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock. The Code computes deemed-paid taxes with regard to dividends from a relevant foreign corporation by looking first to the multi-year pools of earnings and profits accumulated (and related foreign income taxes paid or deemed paid) in taxable years beginning after December 31, 1986, or beginning with the first year in which a domestic corporation owns 10 percent or more of the voting stock of the foreign corporation, whichever is later. Section 902(c). (The Code and regulations refer to pooled earnings and profits and foreign income taxes as post-1986 undistributed earnings and post-1986 foreign income taxes even though a particular corporation may not begin to maintain multi-year pools until after 1986. Sections 902(c)(1) and (2), §1.902–1(a)(8) and (9).)

Congress enacted the pooling rules because it believed that blending foreign income taxes and earnings and profits into "pools" from which distributions are made was fairer and more appropriate than computing deemed-paid taxes with reference to annual layers of earnings and profits (and foreign income taxes). Joint Committee on Taxation, 99th Cong., 2nd sess., General Explanation of the Tax Reform Act of 1986 (JCS–10–87) (1986 Bluebook), at 870 (May 4, 1987). Averaging foreign income taxes through these blended pools prevents taxpayers from inflating their foreign subsidiary's effective tax rate for a particular year in order to obtain artificially enhanced foreign tax credits. *Id.* Averaging also prevents the loss of credits for foreign income taxes that are trapped in years in which a foreign subsidiary has no earnings and profits for U.S. tax purposes. *Id*.

However, Congress enacted pooling on a limited basis. Earnings and profits accumulated (and related foreign income taxes paid or deemed paid) in taxable years before the first year a foreign corporation qualifies as a pooling corporation and pre-1987 earnings and profits accumulated (and related foreign income taxes paid or deemed paid) by a pooling corporation are not subject to the pooling rules. Rather, such earnings and profits (and related foreign income taxes) are maintained in separate annual layers. Section 902(c)(6). The Code and regulations refer to earnings and profits and foreign income taxes in annual layers as pre-1987 accumulated profits and pre-1987 foreign income taxes even though a particular corporation may have annual layers for years after 1986 (because of the absence of the requisite domestic corporate shareholder). Section 902(c)(6); §1.902–1(a)(10).

A distribution of earnings and profits is treated as first out of pooled earnings and profits and then, only after all pooled earnings and profits have been distributed, out of annual layers of earnings and profits on a LIFO basis. Section 902(a) and (c). The retention of annual layers beneath pooled earnings and profits limits the need to recreate tax histories, an administrative burden that is more significant for periods during which a corporation had limited nexus to the U.S. taxing jurisdiction and for pre-1987 earnings and profits when pooling was not required.

The foreign tax credit limitation ensures that taxpayers can use foreign tax credits only to offset U.S. tax on foreign source income. The limitation is computed separately with respect to different baskets of income derived from different types of activities. (From 1987 through 2006, section 904 provides for eight different baskets of income; for tax years beginning after December 31, 2006, all but two section 904(d) baskets of income are eliminated. Separate baskets described in other Code sections such as sections 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), and 904(g)(10) will continue in effect after 2006. The American Jobs Creation Act of 2004, Public Law 108–357, 118 Stat. 1418 (AJCA), section 404(a).) The purpose of the baskets is to limit taxpayers' ability to cross-credit taxes imposed with respect to different categories of income. Congress was concerned that, without separate limitations, cross-crediting opportunities would distort economic incentives as to whether to invest in the United States or abroad. 1986 Bluebook at 862.

Another international provision implicated by the movement of earnings and profits in foreign section 381 transactions is section 959. Section 959 governs the distribution of earnings and profits that represent income that has been previously taxed to U.S. shareholders under section 951(a) (PTI). After studying the interaction of section 367(b) and the PTI rules, the Treasury Department and the IRS determined that more guidance under section 959 would be useful before issuing regulations to address PTI issues that arise under section 367(b). Accordingly, the Treasury Department and the IRS have opened a separate regulations project under section 959 and expect to issue regulations that address PTI issues under section 959 in the future. Because this project is still ongoing, these final regulations reserve on section 367(b) issues related to PTI. Guidance in this area will come in a separate project.

Summary of Comments Received and Changes Made

A. Inbound Nonrecognition Transactions

A comment was received regarding the provision under the 2000 proposed regulations that limits the carryover of earnings and profits (or deficit in earnings and profits) from a foreign corporation to a domestic corporation in an inbound nonrecognition transaction to those earnings and profits that are effectively connected with the conduct of a trade or business within the United States (or are attributable to a permanent establishment in the United States, in the context of an applicable U.S. income tax treaty). The comment suggests that there are better ways to avoid the two most significant problems of importing foreign earnings into domestic corporate solution: potential dividends-received deductions on subsequent distribution of the previously untaxed foreign earnings, and taxing distributions of previously taxed earnings and profits described in section 959. The comment goes on to state that, in particular, eliminating deficits but taxing positive earnings on an inbound nonrecognition transaction by way of the all earnings and profits inclusion under §1.367(b)–3 is inappropriate.

The Treasury Department and the IRS have considered this comment. While the comment identifies asymmetries in the tax treatment of inbound reorganizations, on balance the Treasury Department and the IRS believe that the 2000 proposed regulations reached the appropriate result. As indicated above, the importation of favorable tax attributes has been subject to greater scrutiny in recent years. See, for example, section 362(e). In that context, it is not appropriate to provide for the carryover of deficits or of earnings and profits in excess of the all earnings and profits inclusion. This conclusion also has the benefit of administrative ease for taxpayers and the IRS. Accordingly, these final regulations do not modify the rules regarding inbound nonrecognition transactions as set forth in the 2000 proposed regulations, except to reserve on the treatment of PTI for further consideration.

B. Paradigm Based on Pooling rather than Look-through

The structure of the 2000 proposed regulations was based in large part on the categorization of foreign acquiring, target, and surviving corporations as look-through corporations, non-look-through corporations, or less-than-10%-U.S.-owned foreign corporations. Under the international provisions of the Code in effect at the time the 2000 proposed regulations were published, a look-through corporation included a controlled foreign corporation as defined in section 957 (CFC) or a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) after 2003 (a look-through 10/50 corporation), the effective date of section 1105(b) of Public Law 105–34 (111 Stat. 788) (the 1997 Act). A non-look-through corporation was a noncontrolled section 902 corporation before 2003 (non-look-through 10/50 corporation) and a less-than-10%-U.S.-owned foreign corporation was a foreign corporation that was neither a CFC nor a 10/50 corporation.

The pools of earnings and profits and foreign taxes associated with these three categories of corporations were referred to as the look-through pool, the non-look-through pool, and the pre-pooling annual layers, respectively. A number of statutory and regulatory changes that have occurred since the time the 2000 proposed regulations were published, however, have necessitated appropriate changes (and simplification) in the organizational paradigm for these final regulations.

At the time the 2000 proposed regulations were issued (and continuing prior to the AJCA), the treatment of dividends from a 10/50 corporation paid after 2002 varied according to the year in which the earnings and profits from which the dividend was paid were accumulated. The look-through approach applied to dividends paid out of earnings and profits accumulated after 2002, whereas dividends paid out of earnings and profits accumulated prior to 2003 were subject to a single separate limitation for dividends from all 10/50 corporations. Joint Committee on Taxation, 105th Cong., 1st sess., General Explanation of Tax Legislation enacted in 1997 (JCS–23–97), at 303 (December 17, 1997). The AJCA conference report indicates that Congress changed the treatment of dividends from 10/50 corporations for purposes of simplification. H.R. Rep. No. 108–548, pt. 1 at 192 (2004).

In 2004, Congress amended the Code (the 2004 amendment) to provide that any dividend paid by a noncontrolled section 902 corporation (10/50 corporation), as defined in section 904(d)(2)(E), to a 10 percent or greater U.S. corporate shareholder is treated as income in a basket based on the ratio of the earnings and profits attributable to income in such basket to the foreign corporation's total earnings and profits (the "look-through" approach). AJCA, section 403. The 2004 amendment was effective retroactively, for taxable years beginning after December 31, 2002. Section 403(l) of the Gulf Opportunity Zone Act of 2005, Public Law 109–135 (119 Stat. 2577), permitted taxpayers to elect to defer the effective date of the 2004 amendment to taxable years beginning after December 31, 2004.

Also, as part of the 2004 amendment, dividends paid to 10% domestic corporate shareholders of a CFC are eligible for look-through treatment, even if they are paid out of earnings that were accumulated while the corporation was not a CFC. Section 904(d)(4); see also §1.904–7T(f)(3) and (6). Prior to the effective date of the 2004 amendment, dividends paid out of such earnings were subject to a separate limitation. See 26 CFR 1.904–4(g)(2)(ii) (revised as of April 1, 2006).

As a result of the 2004 amendment, the terms *non-look-through 10/50 corporation* and the related *non-look-through pool* as defined in the 2000 proposed regulations have become obsolete and therefore have been eliminated in these final regulations. More generally, in light of the broader availability of look-through treatment to earnings paid out of pre-pooling annual layers, the Treasury Department and the IRS believe that a paradigm centered on look-through or non-look-through status is less relevant. Accordingly, the organization of these final regulations is based on the categorization of foreign acquiring, target, and surviving corporations as pooling or nonpooling corporations. The relevant pools of earnings and profits and associated foreign taxes are referred to as post-1986 pools and pre-pooling annual layers. Qualifying shareholders are eligible for look-through treatment on dividends out of post-1986 pools and pre-pooling annual layers to the extent provided in section 904(d)(3) and (4).

C. Hovering Deficits and Section 316

Comments were received regarding the application under the 2000 proposed regulations of the hovering deficit rules on a "basket-by-basket" basis. Under the 2000 proposed regulations, a pre-transaction deficit in a particular basket is generally subject to the hovering deficit rule of section 381. As a result, that deficit is not taken into account in determining the current or accumulated earnings and profits of the surviving corporation for any purpose, including for purposes of determining dividends under section 316 and for determining foreign tax credits under section 902. However, any such pre-transaction deficits in earnings and profits may be used to offset a foreign surviving corporation's accumulated (but not current) post-transaction earnings and profits in the same basket as the deficit.

Several comments noted that, in certain circumstances, this rule can give rise to hovering deficits from one (or both) of the merging corporations even if it (or they) had aggregate positive earnings and profits immediately prior to the section 381 transaction. In addition, if one (or both) of the merging corporations' pre-transaction earnings consist both of positive earnings in one basket and a deficit in another basket, the earnings and profits of that corporation available to support a dividend under section 316 will increase solely as a result of entering into the section 381 transaction. This is because the hovering deficit will no longer offset the positive earnings in the other basket for purposes of section 316. As a result, even if a corporation has an aggregate deficit in earnings and profits, any positive baskets of earnings will be able to support the distribution of a dividend immediately after the transaction.

The comments contend that the prohibition described above against the use of an earnings and profits deficit in one basket from offsetting positive earnings and profits in another basket can produce results that are inconsistent with the result of applying a pure section 381(c)(2)(B) approach in determining the amount of a distribution that is a "dividend" under section 316, and more generally are inconsistent with the principles and legislative history of the section 381(c)(2)(B) hovering deficit rule, which was adopted to preserve, but not create, the taxation of distributions by corporations that engage in tax-free reorganizations or liquidations.

To address these concerns, the comments requested that (among other things) the proposed regulations be modified to conform to the principles contained in Notice 88–71, 1988–2 C.B. 374, and §1.960–1(i)(4), which pro-rate an earnings and profits deficit in one basket against positive earnings and profits in other baskets for purposes of computing post-1986 undistributed earnings under section 902. It was also requested that the rules under §1.960–1(i)(4) should be modified for purposes of the hovering deficit rules to eliminate the "springing" effect of an earnings and profits deficit. Section 1.960–1(i)(4) provides that a deficit in any basket does not permanently reduce earnings in other baskets, but after the deemed-paid taxes are computed, the deficit reverts to and is carried forward in the same basket in which it was incurred. It was asserted in the comments that once a hovering deficit is used to reduce earnings in another basket, it should not revert to its original basket in a subsequent taxable year because this deficit reincarnation results in unnecessary complexity in the calculation of earnings and profits.

The Treasury Department and the IRS have carefully considered these comments. After this consideration, they have concluded that the arguments in these comments ultimately are not persuasive. The purpose of the hovering deficit rule in the domestic context is to prevent trafficking in deficits in earnings and profits. Absent this rule, a corporation with positive earnings and profits could acquire or be acquired by another corporation with a deficit in earnings and profits and immediately reduce the amount of its positive earnings and profits, thereby reducing the amount of potentially taxable distributions.

In transactions involving foreign corporations, similar concerns exist regarding the possibility of trafficking in deficits in earnings and profits. In light of the foreign tax credit rules, unique tax benefits may arise from combining positive and deficit earnings and profits of different foreign corporations. In a reorganization involving two domestic corporations, the hovering deficit rule applies to a corporation with a net accumulated deficit in earnings and profits because the relevant statutory rules do not distinguish among classes of earnings and profits. In contrast, the foreign tax credit rules require categorization of earnings and profits according to the pooling and basket rules. Because of these distinctions, taxpayers may inappropriately benefit by trafficking in an earnings and profits deficit in a basket, pool, or particular annual layer, even though a corporation may have net positive earnings and profits. The Treasury Department and the IRS believe that these issues merit targeted differences in the application of the hovering deficit rule in this context. Accordingly, these final regulations retain the provisions of the 2000 proposed regulations that apply the hovering deficit rule on a basket-by-basket basis.

The final regulations also include a clarification that post-transaction earnings and profits that may be offset by hovering deficits do not include earnings and profits that are distributed or deemed distributed in the same taxable year that they are earned. That is, the hovering deficit rule does not permit deficits to be offset against post-transaction earnings and profits until those earnings and profits become accumulated (as opposed to current) for tax purposes. This rule is consistent with a similar provision in the hovering deficit regulations under section 381. See §1.381(c)(2)–1(a)(5).

D. Hovering Deficits and Section 902

Under section 902, the amount of foreign taxes that are deemed paid by a 10% domestic corporate shareholder receiving dividends from a foreign corporation is equal to the foreign corporation's post-1986 foreign income taxes multiplied by a fraction, the numerator of which is the amount of the dividend, and the denominator of which is the foreign corporation's post-1986 undistributed earnings. Post-1986 undistributed earnings include both accumulated and current year earnings and deficits, not taking into account current year distributions. The section 902 calculation is done on a basket-by-basket basis. The 2000 proposed regulations provide that a pre-transaction deficit will only be taken into account for purposes of determining the accumulated earnings and profits of the surviving corporation in the section 902 denominator to the extent of post-transaction earnings that are accumulated in the same basket as the deficit.

A comment was made requesting that the hovering deficit rule not apply for purposes of computing deemed-paid credits under section 902, particularly in the determination of accumulated earnings and profits in the denominator of the section 902 fraction. Under this approach, the effect of the inclusion of an otherwise hovering deficit on the section 902 calculation could be beneficial or detrimental to the taxpayer, depending on the particular taxpayer's facts. For example, the suggested approach would be detrimental to taxpayers if the unrestricted use of the otherwise hovering deficit reduced the denominator of the section 902 fraction to or below zero. See §1.902–1(b)(4) (providing that no taxes are deemed paid with respect to a "nimble dividend" if post-1986 undistributed earnings are zero or less than zero). The rationale offered for this request is that it would more properly follow the intent of Congress when it amended section 902 in 1986 to average earnings and profits and foreign taxes under a pooling method.

After consideration of the comment, the Treasury Department and the IRS have concluded that it would not be appropriate to allow a pre-transaction hovering deficit from one corporation to offset pre-transaction earnings and profits of another corporation for purposes of determining the denominator of the section 902 fraction. Such an offset could increase the ratio of foreign taxes to earnings and profits in the pool and thereby in certain cases could "supercharge" the amount of foreign taxes that could be drawn out by a given distribution. The Treasury Department and the IRS believe this is not an appropriate result and could encourage taxpayers to enter into section 381 transactions to take advantage of the distortion that would result from accelerating foreign tax credits in certain cases. It is also possible that such a rule could be detrimental to taxpayers by otherwise denying them access to creditable foreign income taxes if their section 902 denominator were eliminated. Moreover, the comment would further complicate an already complex area by mandating one set of hovering deficit treatment and calculations of earnings for section 316 and another for section 902.

An alternative request was made to the effect that, if the hovering deficit rule is retained, it should be modified to allow a pre-transaction earnings and profits deficit to offset the surviving corporation's post-transaction current year earnings and profits for purposes of determining the section 902 denominator, irrespective of whether such earnings are distributed during the taxable year.

After considering this comment, the Treasury Department and the IRS concluded that on balance it would not be appropriate to modify the proposed regulations in this manner. In many cases, allowing the hovering deficit to offset current year distributed earnings and profits for purposes of the section 902 denominator would effectively allow an offset of pre-transaction earnings and profits. This is because the opening balance of post-1986 undistributed earnings in the year following the distribution would be reduced a second time (the first reduction having occurred as a result of offsetting the current year distributed earnings and profits by the hovering deficit) as required by section 902 and the regulations thereunder to account for the distribution itself. This second reduction would reduce pre-transaction earnings and profits or, to the extent of any excess over that amount, create a deficit in accumulated earnings and profits. As described, the Treasury Department and the IRS believe that in order to minimize credit trafficking problems, pre-transaction deficits of one corporation should not be allowed to offset pre-transaction earnings of another corporation.

Additionally, implementing the modification requested in the comment would create administrative burdens for taxpayers and the IRS. If hovering deficits offset current year distributed earnings solely for purposes of section 902 but not for purposes of section 316, dual accounts would be necessary to track hovering deficits as they are separately used under each section.

Moreover, certain taxpayers would be disadvantaged under the requested modification as compared to how those taxpayers would be treated under the rule adopted in these final regulations. For example, if a foreign subsidiary has a hovering deficit in a separate basket that exceeds the sum of current plus accumulated earnings in the basket and the foreign subsidiary distributes current year post-transaction earnings in that same basket, under the requested modification, the hovering deficit would reduce the section 902 denominator to zero, with the result that no deemed-paid taxes could be claimed on the distribution. In fact, for this reason certain taxpayers have specifically requested that the hovering deficit rule apply for purposes of the section 902 fraction. Under the rules adopted by the final regulations, the hovering deficit would not reduce the section 902 denominator and therefore taxpayers would have access to deemed-paid taxes on the distribution.

E. Hovering Taxes

Under the 2000 proposed regulations, taxes associated with a hovering deficit do not enter into the surviving corporation's post-1986 foreign income taxes pool until the entire deficit has been offset against post-transaction accumulated earnings and profits. Comments were made requesting that the regulations be changed to provide that foreign taxes related to a hovering deficit enter the post-1986 foreign income taxes pool on a *pro rata* basis as the hovering deficit to which the foreign taxes relate is used to offset post-transaction accumulated earnings and profits. The Treasury Department and IRS agree that a *pro rata* approach of this nature more accurately ties the availability of the foreign income taxes with the use of the related hovering deficit. Accordingly, this requested change is reflected in the final regulations.

F. Zipping Rule

The 2000 regulations provide that if the foreign target corporation or foreign acquiring corporation (or both) was a look-through corporation and the foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation, the post-1986 pools of earnings and profits of the look-through corporation in the separate baskets are recharacterized as a single, non-look-through pre-pooling annual layer which accumulated immediately prior to the 381 transaction (the zipping rule). In addition, the 2000 proposed regulations provide that if the foreign surviving corporation later changes to look-through status, any such recharacterized earnings and profits do not regain either their pooling or their look-through character.

A comment was made that in a case where the foreign surviving corporation subsequently changes to look-through status, if the recharacterized earnings and profits do not revert to their look-through character, a dividend paid out of those earnings would not be afforded look-through treatment. The comment argued that this would run counter to section 904(d)(2)(E)(i) which provides that look-through treatment applies to distributions by a CFC out of any earnings and profits accumulated during periods in which it was a CFC.

The Treasury Department and IRS note that this concern has been addressed by intervening statutory and regulatory changes. All distributions from a look-through corporation now receive look-through treatment, regardless of whether they are paid out of earnings and profits from post-1986 pools or pre-pooling annual layers. As a result, the concern raised in the comment is now effectively moot, and look-through treatment generally prevails. The final regulations otherwise retain the zipping rule, however, because with respect to the maintenance of pools or annual layers, this rule provides administrative advantages for both taxpayers and the IRS by not requiring subsequent U.S. shareholders of a foreign surviving corporation that continued to accumulate earnings on an annual layer basis to recreate post-1986 pools of pre-transaction earnings and profits carried over from a pooling foreign target corporation. Accordingly, the Treasury Department and the IRS decided to retain the general zipping rule provisions of the 2000 proposed regulations in these final regulations for pooling purposes, while allowing full preservation of look-through treatment.

Moreover, it should be noted that these final regulations define a pooling corporation as one that has at any time met the requirements of section 902(c)(3)(B). Accordingly, even if the foreign surviving corporation does not meet those requirements immediately after the foreign section 381 transaction, it will still be a pooling corporation if it had met those requirements at any time prior to the transaction. See §1.902–1(a)(13)(i).

G. Qualified and Chain Deficit Rules Under Section 952(c)(1)(B) and (C)

The section 952(c)(1)(B) subpart F qualified deficit rule and section 952(c)(1)(C) subpart F chain deficit rule allow the use of a CFC's deficit in earnings and profits to limit subpart F income inclusions for another year with respect to the stock of the same CFC or for the same year with respect to stock of another CFC in certain cases. Under the qualified deficit rule of section 952(c)(1)(B), a prior-year earnings and profits deficit may be used to limit a qualified shareholder's current year subpart F income in the same CFC if such deficit is attributable to the same qualified activity as the activity that gives rise to the current year subpart F income. Under the chain deficit rule of section 952(c)(1)(C), a current year earnings and profits deficit may be used to limit a related corporation's current year subpart F income subject to the same qualified activity restrictions.

The 2000 proposed regulations provide that a pre-transaction deficit is not taken into account for purposes of calculating the earnings and profits limitation under the chain deficit rule. The 2000 proposed regulations are silent, however, as to the qualified deficit rule. A comment was made requesting that pre-transaction deficits be taken into account for purposes of calculating the earnings and profits limitations under both the qualified deficit rules and the chain deficit rules.

The Treasury Department and the IRS agree with this comment. The qualified deficit rule does not limit the amount of the subpart F income at the CFC level, but rather limits the amount of a particular shareholder's subpart F income inclusion under section 951(a). Because qualified deficits in earnings and profits are shareholder-level attributes and anti-trafficking provisions are already incorporated in the rules regarding qualified deficits under section 952(c)(1)(B), the Treasury Department and the IRS believe that it is appropriate to allow pre-transaction deficits to be taken into account for purposes of the calculation of qualified deficits. Though the Treasury Department and IRS believe this was already a reasonable position that could have been taken under the 2000 proposed regulations, the final regulations include a more explicit clarification of this position.

The final regulations also provide that a current year pre-transaction deficit may be taken into account for purposes of limiting subpart F income under the chain deficit rule. The Treasury Department and the IRS believe that the narrow restrictions that apply to application of the chain deficit rule are not subject to manipulation through entering into foreign section 381 transactions. Accordingly there is no policy reason for denying a qualified chain member access to a pre-transaction deficit that otherwise qualifies as a chain deficit solely because the CFC with the chain deficit engaged in a foreign section 381 transaction during the taxable year. Any such pre-transaction deficit that qualifies as a chain deficit will nonetheless remain a hovering deficit of the surviving corporation for purposes of section 316 and section 902.

H. Allocation of Earnings and Profits, Deficits, and Taxes During the Transaction Year

The 2000 proposed regulations include a rule that allocates the earnings and profits for the taxable year of a foreign surviving corporation in which a foreign section 381 transaction occurs as either pre-transaction earnings or post-transaction earnings on the basis of the number of days in the taxable year before and after the date of the foreign section 381 transaction. This rule parallels a similar rule found under §1.381(c)(2)–1(a)(6) and is necessary in order to determine the amount of post-transaction earnings that may be offset by hovering deficits. This rule is applied on a basket-by-basket basis for any basket in which there are positive earnings and profits for the taxable year in which the transaction occurred. No comments were received on this point, and the final regulations adopt this provision, extending it to related foreign income taxes as well.

These final regulations also contain a rule for allocating deficits, and related foreign income taxes, for the taxable year in which a foreign section 381 transaction occurs as pre- and post-transaction deficits. If the surviving corporation has a deficit in any basket for the taxable year in which the transaction occurred, unless the actual accumulated earnings and profits, or deficit, as of the date of the transaction can be shown, the deficit shall be allocated in the same *pro rata* manner described above for positive earnings and profits. This rule also parallels a similar rule found under §1.381(c)(2)–1(a)(6) and is necessary in order to determine the amount of pre-transaction deficits that will hover. This rule is applied on a basket-by-basket basis for any basket in which there is a deficit in earnings and profits for the taxable year in which the transaction occurred.

The Treasury Department and the IRS believe that the addition of the allocation rule for deficits provides greater consistency with the principles and rules of section 381. It is a neutral provision and is consistent with appropriate results that could be reached under present law.

I. Special Rule for F Reorganizations and Similar Transactions

The 2000 proposed regulations (Prop. Reg. §1.367(b)–9) provide that the hovering deficit rules do not apply in the case of a foreign section 381 transaction that is described in section 368(a)(1)(F) or in which either the foreign target corporation or the foreign acquiring corporation is newly created. This rule was intended to prevent inappropriate tax consequences that could result from application of the hovering deficit rules to the combination of two corporations where only one of those corporations has meaningful tax attributes. For example, under the generally applicable hovering deficit rules, a foreign corporation with significant deficits in earnings and profits could combine with a newly created foreign corporation and thereafter distribute dividends (along with deemed paid foreign income taxes under section 902), despite the presence of a significant deficit that would have precluded a dividend distribution before the transaction.

The rule under the 2000 proposed regulations addressing newly created corporations was meant to capture any transactions that are functionally equivalent to F reorganizations. However, the Treasury Department and the IRS have determined that the newly-created corporation standard under the 2000 proposed regulations is both potentially underinclusive and overinclusive in scope. It is underinclusive in that it would not apply to include foreign section 381 transactions that do not otherwise qualify as an F reorganization but that are between one foreign corporation with meaningful tax attributes and a shell corporation that is not newly created, but nevertheless has no meaningful tax attributes. In contrast, this standard is overinclusive in that it might be read to include a foreign section 381 transaction involving multiple foreign corporations with meaningful tax attributes as long as at least one party to the transaction is a newly created corporation. These transactions are neither F reorganizations nor are they functionally equivalent to F reorganizations.

Accordingly, these final regulations clarify the 2000 proposed regulations by providing that the hovering deficit rules do not apply to a foreign section 381 transaction involving at least one corporation that does not own more than a nominal amount of property or does not have more than a nominal amount of tax attributes, but no more than one corporation that does own more than a nominal amount of property or have more than a nominal amount of tax attributes. In most cases the transactions covered by this special rule will be standard F reorganizations.

J. Anti-abuse Rule

The 2000 proposed regulations include an anti-abuse rule that gives the Commissioner the discretion to turn off the hovering deficit rules if a principal purpose of a foreign section 381 transaction is to gain a tax benefit from affirmative use of those rules. Comments have criticized the anti-abuse rule as overly broad and inconsistent with establishing objective rules regarding the taxation of earnings distributed (or deemed distributed) by foreign subsidiaries. Moreover, the point was raised in some comments that the proposed anti-abuse rule would prevent taxpayers from relying on the existing detailed set of rules for the calculation of earnings and profits following a corporate combination in any case in which a taxpayer receives a U.S. tax benefit related to the application of the hovering deficit rule.

Upon consideration of these comments, the Treasury Department and the IRS have concluded that the anti-abuse rule in the 2000 proposed regulations should be eliminated. While the anti-abuse rule has been eliminated, the IRS will continue to examine the application of the regulations to transactions to which they apply, or potentially apply, and will be prepared to pursue issues where appropriate under the regulations and other established principles of existing law. The Treasury Department and the IRS may revisit the rules in light of experience and propose prospective changes as appropriate.

K. Miscellaneous

A number of conforming revisions have been made to the 2000 proposed regulations to account for relevant statutory and regulatory changes discussed above that have occurred in the intervening time period since the 2000 proposed regulations were issued. This includes the reduction of the number of baskets under section 904(d)(1), applicable for tax years beginning after December 31, 2006, as well as the fact that distributions by look-through corporations out of annual layers accumulated during a non-look-through period are now accorded look-through treatment.

It is possible that special transition rules might be needed relating to the effect on hovering deficits in existence on the effective date of the reduction in the number of baskets under section 904(d)(1). If it is determined that such rules are necessary, they would be provided as part of a broader guidance project currently under consideration to address generally transition issues relating to the reduction in baskets.

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. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations 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 final regulations is Jeffrey L. Parry of the Office of Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entries for §§1.367(b)–7 and 1.367(b)–9 to read in part as follows:

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

Section 1.367(b)–7 also issued under 26 U.S.C. 367(a) and (b), 26 U.S.C. 902, and 26 U.S.C. 904.

Section 1.367(b)–9 also issued under 26 U.S.C. 367(a) and (b), 26 U.S.C. 902, and 26 U.S.C. 904. * * *

Par. 2. Section 1.367(b)–0 is amended by:

1. Revising the introductory text.
2. Adding entries for §1.367(b)–2(l).
3. Adding entries for §1.367(b)–3(e) and (f).
4. Adding entries for §§1.367(b)–7 through 1.367(b)–9.

The revisions and additions read as follows:

§1.367(b)–0 Table of contents.

This section lists the paragraphs contained in §§1.367(b)–1 through 1.367(b)–9.

* * * * *

§1.367(b)–2 Definitions and special rules.

* * * * *

(l) Additional definitions.
(1) Foreign income taxes.
(2) Post-1986 undistributed earnings.
(3) Post-1986 foreign income taxes.
(4) Pre-1987 accumulated profits.
(5) Pre-1987 foreign income taxes.
(6) Pre-1987 section 960 earnings and profits.
(7) Pre-1987 section 960 foreign income taxes.
(8) Earnings and profits.
(9) Pooling corporation.
(10) Nonpooling corporation.
(11) Separate category.
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(13) General category.

§1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

* * * * *

(e) Net operating loss and capital loss carryovers.
(f) Carryover of earnings and profits.
(1) General rule
(2) Previously taxed earnings and profits. [Reserved]

* * * * *

§1.367(b)–7 Carryover of earnings and profits and foreign income taxes in

certain foreign-to-foreign nonrecognition transactions.

(a) Scope.
(b) General rules.
(1) Non-previously taxed earnings and profits and related taxes.
(2) Previously taxed earnings and profits. [Reserved]
(c) Ordering rule for post-transaction distributions.
(1) If foreign surviving corporation is a pooling corporation.
(2) If foreign surviving corporation is a nonpooling corporation.
(d) Post-1986 pool.
(1) In general.
(i) Qualifying earnings and taxes.
(ii) Carryover rule.
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(i) In general.
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(3) Examples.
(e) Pre-pooling annual layers.
(1) If foreign surviving corporation is a pooling corporation.
(i) Qualifying earnings and taxes.
(ii) Carryover rule.
(iii) Deficits.
(A) In general.
(B) Aggregate positive pre-1987 accumulated profits.
(C) Aggregate deficit in pre-1987 accumulated profits.
(D) Deficit and positive separate categories within annual layers.
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(v) Examples.
(2) If foreign surviving corporation is a nonpooling corporation.
(i) Qualifying earnings and taxes.
(ii) Carryover rule.
(iii) Deficits.
(A) In general.
(B) Aggregate positive pre-1987 accumulated profits.
(C) Aggregate deficit in pre-1987 accumulated profits.
(D) Deficit and positive separate categories within annual layers.
(iv) Pre-1987 section 960 earnings and profits and foreign income taxes.
(v) Examples.
(f) Special rules.
(1) Treatment of deficit.
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(ii) Exceptions.
(iii) Examples.
(2) Reconciling taxable years.
(3) Post-transaction change of status.
(4) Ordering rule for multiple hovering deficits.
(i) Rule.
(ii) Example.
(5) *Pro rata* rule for earnings and deficits during transaction year.
(g) Effective date.

§1.367(b)–8 Allocation of earnings and profits and foreign income taxes in certain foreign corporate separations. [Reserved]

§1.367(b)–9 Special rule for F reorganizations and similar transactions.

(a) Scope.
(b) Hovering deficit rules inapplicable.
(c) Foreign divisive transactions. [Reserved]
(d) Examples.
(e) Effective date.

Par. 3. Section 1.367(b)–1 is amended by:

1. Removing the language "and" at the end of paragraph (c)(2)(iii).
2. Removing the period at the end of paragraph (c)(2)(iv)(B) and adding "; and" in its place.
3. Adding paragraph (c)(2)(v).
4. Revising paragraphs (c)(3)(ii)(A), (c)(4)(iv), and (c)(4)(v).

The additions and revisions read as follows:

§1.367(b)–1 Other transfers.

* * * * *

(c) * * *

(2) * * *

(v) A foreign surviving corporation described in §1.367(b)–7(a).

(3) * * *

(ii) * * *

(A) United States shareholders (as defined in §1.367(b)–3(b)(2)) of foreign corporations described in paragraph (c)(2)(i) or (v) of this section; and

* * * * *

(4) * * *

(iv) A statement that describes any amount (or amounts) required, under the section 367(b) regulations, to be taken into account as income or loss or as an adjustment (including an adjustment under §1.367(b)–7 or 1.367(b)–9) to basis, earnings and profits, or other tax attributes as a result of the exchange;

(v) Any information that is or would be required to be furnished with a Federal income tax return pursuant to regulations under section 332, 351, 354, 355, 356, 361, 368, or 381 (whether or not a Federal income tax return is required to be filed), if such information has not otherwise been provided by the person filing the section 367(b) notice;

* * * * *

Par. 4. Section 1.367(b)–2 is amended by:

1. Revising paragraph (j)(1)(i).
2. Adding paragraph (l).

The revision and addition read as follows:

§1.367(b)–2 Definitions and special rules.

* * * * *

(j) *Sections 985 through 989*—(1) *Change in functional currency of a qualified business unit*—(i) *Rule*. If, as a result of a section 367(b) exchange described in section 381(a), a qualified business unit (as defined in section 989(a)) (QBU) has a different functional currency determined under the rules of section 985(b) than it used prior to the transaction, then the QBU shall be deemed to have automatically changed its functional currency immediately prior to the transaction. A QBU that is deemed to change its functional currency pursuant to this paragraph (j) must make the adjustments described in §1.985–5.

* * * * *

(l) *Additional definitions*—(1) *Foreign income taxes*. The term *foreign income taxes* has the meaning set forth in §1.902–1(a)(7).

(2) *Post-1986 undistributed earnings*. The term *post-1986 undistributed earnings* has the meaning set forth in §1.902–1(a)(9).

(3) *Post-1986 foreign income taxes*. The term *post-1986 foreign income taxes* has the meaning set forth in §1.902–1(a)(8).

(4) *Pre-1987 accumulated profits*. The term *pre-1987 accumulated profits* means the earnings and profits described in §1.902–1(a)(10)(i), computed in accordance with the rules of §1.902–1(a)(10)(ii).

(5) *Pre-1987 foreign income taxes*. The term *pre-1987 foreign income taxes* has the meaning set forth in §1.902–1(a)(10)(iii).

(6) *Pre-1987 section 960 earnings and profits*. The term *pre-1987 section 960 earnings and profits* means the earnings and profits of a foreign corporation accumulated in taxable years beginning before January 1, 1987, computed under §1.964–1(a) through (e), and translated into the functional currency (as determined under section 985) of the foreign corporation at the spot rate on the first day of the foreign corporation's first taxable year beginning after December 31, 1986. For further guidance, see Notice 88–70, 1988–2 C.B. 369, 370 (see also §601.601(d)(2) of this chapter). The term pre-1987 section 960 earnings and profits does not include earnings and profits that represent previously taxed earnings and profits described in section 959.

(7) *Pre-1987 section 960 foreign income taxes*. The term *pre-1987 section 960 foreign income taxes* means the foreign income taxes related to pre-1987 section 960 earnings and profits, determined in accordance with the principles of §1.902–1(a)(10)(iii), except that the U.S. dollar amounts of pre-1987 section 960 foreign income taxes are determined by reference to the exchange rates in effect when the taxes were paid or accrued.

(8) *Earnings and profits*. The term *earnings and profits* means post-1986 undistributed earnings, pre-1987 accumulated profits, and pre-1987 section 960 earnings and profits.

(9) *Pooling corporation*. The term *pooling corporation* means a foreign corporation with respect to which the requirements of section 902(c)(3)(B) have been met in the current taxable year or any prior taxable year.

(10) *Nonpooling corporation*. The term *nonpooling corporation* means a foreign corporation that is not a pooling corporation.

(11) *Separate category*. The term *separate category* has the meaning set forth in section 904(d)(1), and shall also include any other category of income to which section 904(a), (b), and (c) are applied separately under any other provision of the Internal Revenue Code (*e.g.*, sections 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), and 904(h)(10) (or section 904(g)(10) for taxable years beginning on or before December 31, 2006)).

(12) *Passive category*. The term *passive category* means the separate category that includes income described in section 904(d)(1)(A).

(13) *General category*. The term *general category* means the separate category that includes income described in section 904(d)(1)(B) (or section 904(d)(1)(I) for taxable years beginning on or before December 31, 2006).

Par. 5. Section 1.367(b)–3 is amended by adding paragraphs (e) and (f) to read as follows:

§1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

* * * * *

(e) *Net operating loss and capital loss carryovers*. A net operating loss or capital loss carryover of the foreign acquired corporation is described in section 381(c)(1) and (c)(3) and thus is eligible to carry over from the foreign acquired corporation to the domestic acquiring corporation only to the extent the underlying deductions or losses were allowable under chapter 1 of subtitle A of the Internal Revenue Code. Thus, only a net operating loss or capital loss carryover that is effectively connected with the conduct of a trade or business within the United States (or that is attributable to a permanent establishment, in the context of an applicable United States income tax treaty) is eligible to be carried over under section 381. For further guidance, see Rev. Rul. 72–421, 1972–2 C.B. 166 (see also §601.601(d)(2) of this chapter).

(f) *Carryover of earnings and profits*—(1) *General rule*. Except to the extent otherwise specifically provided (see, *e.g.*, Notice 89–79, 1989–2 C.B. 392 (see also §601.601(d)(2) of this chapter)), earnings and profits of the foreign acquired corporation that are not included in income as a deemed dividend under the section 367(b) regulations (or deficit in earnings and profits) are eligible to carry over from the foreign acquired corporation to the domestic acquiring corporation under section 381(c)(2) only to the extent such earnings and profits (or deficit in earnings and profits) are effectively connected with the conduct of a trade or business within the United States (or are attributable to a permanent establishment in the United States, in the context of an applicable United States income tax treaty). All other earnings and profits (or deficit in earnings and profits) of the foreign acquired corporation shall not carry over to the domestic acquiring corporation and, as a result, shall be eliminated.

(2) *Previously taxed earnings and profits*. [Reserved]

* * * * *

Par. 6. In §1.367(b)–6, paragraph (a)(1) is revised to read as follows:

§1.367(b)–6 Effective dates and coordination rules.

(a) *Effective date*—(1) *In general*. Sections 1.367(b)–1 through 1.367(b)–3, and this section, apply to section 367(b) exchanges that occur on or after November 6, 2006. For guidance with respect to section 367(b) exchanges that occur prior to November 6, 2006, see §§1.367(b)–1 through 1.367(b)–6 in effect prior to November 6, 2006 (see 26 CFR part 1 revised as of April 1, 2006).

Par. 7. Section 1.367(b)–7 is added to read as follows:

§1.367(b)–7 Carryover of earnings and profits and foreign income taxes in certain foreign-to-foreign nonrecognition transactions.

(a) *Scope*. This section applies to an acquisition by a foreign corporation (foreign acquiring corporation) of the assets of another foreign corporation (foreign target corporation) in a transaction described in section 381 (foreign section 381 transaction). This section describes the manner and extent to which earnings and profits and foreign income taxes of the foreign acquiring corporation and the foreign target corporation carry over to the surviving foreign corporation (foreign surviving corporation) and the ordering of distributions by the foreign surviving corporation. See §1.367(b)–9 for special rules governing reorganizations described in section 368(a)(1)(F) and foreign section 381 transactions involving foreign corporations that hold no property and have no tax attributes immediately before the transaction, other than a nominal amount of assets (and related tax attributes).

(b) *General rules*—(1) *Non-previously taxed earnings and profits and related taxes*. Earnings and profits and related foreign income taxes of the foreign acquiring corporation and the foreign target corporation (pre-transaction earnings and pre-transaction taxes, respectively) shall carry over to the foreign surviving corporation in the manner described in paragraphs (d), (e), and (f) of this section. Dividend distributions by the foreign surviving corporation (post-transaction distributions) shall be out of earnings and profits and shall reduce related foreign income taxes in the manner described in paragraph (c) of this section.

(2) *Previously taxed earnings and profits*. [Reserved]

(c) *Ordering rule for post-transaction distributions*. Dividend distributions out of a foreign surviving corporation's earnings and profits shall be ordered in accordance with the rules of paragraph (c)(1) or (2) of this section, depending on whether the foreign surviving corporation is a pooling corporation or a nonpooling corporation.

(1) *If foreign surviving corporation is a pooling corporation*. In the case of a foreign surviving corporation that is a pooling corporation, post-transaction distributions shall be first out of the post-1986 pool (as described in paragraph (d) of this section) and second out of the pre-pooling annual layers (as described in paragraph (e)(1) of this section) under an annual last-in, first-out (LIFO) method.

(2) *If foreign surviving corporation is a nonpooling corporation*. In the case of a foreign surviving corporation that is a nonpooling corporation, post-transaction distributions shall be out of the pre-pooling annual layers (as described in paragraph (e)(2) of this section) under the LIFO method.

(d) *Post-1986 pool*. If the foreign surviving corporation is a pooling corporation, then the post-1986 pool shall be determined under the rules of this paragraph (d).

(1) *In general*—(i) *Qualifying earnings and taxes*. The post-1986 pool shall consist of the post-1986 undistributed earnings and related post-1986 foreign income taxes of the foreign acquiring corporation and the foreign target corporation.

(ii) *Carryover rule*. Subject to paragraph (d)(2) of this section, the amounts described in paragraph (d)(1)(i) of this section attributable to the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation and shall be combined on a separate category-by-separate category basis.

(2) *Hovering deficit*—(i) *In general*. If immediately prior to the foreign section 381 transaction either the foreign acquiring corporation or the foreign target corporation has a deficit in one or more separate categories of post-1986 undistributed earnings or an aggregate deficit in pre-1987 accumulated profits, such deficit will be a hovering deficit of the foreign surviving corporation. The rules of this paragraph (d)(2) apply to hovering deficits in separate categories of post-1986 undistributed earnings. See paragraphs (e)(1)(iii) and (e)(2)(iii) of this section for rules that apply to hovering deficits in pre-1987 accumulated profits. If the foreign acquiring corporation and the foreign target corporation each have a post-1986 hovering deficit in the same separate category of post-1986 undistributed earnings, such deficits and their related post-1986 foreign income taxes shall be combined for purposes of applying this paragraph (d)(2). See also paragraphs (f)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (d)(2)).

(ii) *Offset rule*. A hovering deficit in a separate category of post-1986 undistributed earnings shall offset only earnings and profits accumulated by the foreign surviving corporation after the foreign section 381 transaction (post-transaction earnings) in the same separate category of post-1986 undistributed earnings. For purposes of this rule, however, post-transaction earnings do not include post-1986 undistributed earnings in the same category that are earned after the foreign section 381 transaction, but are distributed or deemed distributed in the same year they are earned (that is, that do not become accumulated). The offset shall occur as of the first day of the foreign surviving corporation's first taxable year following the year in which the post-transaction earnings accumulated.

(iii) *Related taxes*. Post-1986 foreign income taxes that are related to a hovering deficit in a separate category of post-1986 undistributed earnings shall only be added to the foreign surviving corporation's post-1986 foreign income taxes in that separate category on a *pro rata* basis as the hovering deficit is absorbed. *Pro rata* means in the same proportion as the portion of the hovering deficit that offsets post-transaction earnings in the separate category under paragraph (d)(2)(ii) of this section bears to the total amount of the hovering deficit.

(3) *Examples*. The following examples illustrate the rules of this paragraph (d). The examples assume the following facts: foreign corporations A and B are controlled foreign corporations (CFCs) that were incorporated after December 31, 1986, have always been pooling corporations, and have always had calendar taxable years. None of the shareholders of foreign corporations A and B are required to include any amount in income under §1.367(b)–4 as a result of the foreign section 381 transaction. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Finally, unless otherwise stated, any post-1986 undistributed earnings in the passive category resulted from a look-through dividend that was paid by a lower-tier CFC out of earnings accumulated when the CFC was a noncontrolled section 902 corporation and that qualified for the subpart F same-country exception under section 954(c)(3)(A). The examples are as follows:

Example 1. (i) *Facts*. (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Foreign Corporation A		
Separate Category	E&P	Foreign Taxes
General	300u	$ 60
Passive	100u	$ 40
	400u	$100

Foreign Corporation B		
Separate Category	E&P	Foreign Taxes
General	300u	$70

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result.* Under the rules described in paragraph (d)(1) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Separate Category	E&P	Foreign Taxes
General	600u	$130
Passive	100u	$ 40
	700u	$170

(iii) *Post-transaction distribution*. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 350u to its shareholders. Under the rules described in §1.902–1(d)(1) and paragraph (c)(1) of this section, the distribution is out of, and reduces, post-1986 undistributed earnings and post-1986 foreign income taxes in the separate categories on a *pro rata* basis, as follows:

Separate Category	E&P	Foreign Taxes
General	300u	$65
Passive	50u	$20
	350u	$85

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Separate Category	E&P	Foreign Taxes
General	300u	$65
Passive	50u	$20
	350u	$85

Example 2. (i) *Facts*. (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Foreign Corporation A		
Separate Category	E&P	Foreign Taxes
General	200u	$30
Passive	(100u)	$10
	100u	$40

Foreign Corporation B		
Separate Category	E&P	Foreign Taxes
General	300u	$60
Passive	100u	$30
	400u	$90

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result*. Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	500u		$ 90	
Passive	100u	(100u)	$ 30	$10
	600u	(100u)	$120	$10

(iii) *Post-transaction distribution*. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 300u to its shareholders. Under the rules described in §1.902–1(d)(1) and paragraph (c)(1) of this section, the distribution is out of, and reduces, post-1986 undistributed earnings and post-1986 foreign income taxes on a *pro rata* basis as follows:

Separate Category	E&P	Foreign Taxes
General	250u	$45
Passive	50u	$15
	300u	$60

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	250u		$45	
Passive	50u	(100u)	$15	$10
	300u	(100u)	$60	$10

(iv) *Post-transaction earnings*—(A) In its taxable year ending on December 31, 2008, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

Separate Category	E&P	Foreign Taxes
General	100u	$20
Passive	50u	$10
	150u	$40

(B) None of foreign surviving corporation's earnings and profits for its 2008 taxable year qualifies as subpart F income as defined in section 952(a). Under the rules described in paragraphs (d)(2)(ii) and (iii) of this section, the hovering deficit in the passive category will offset the post-transaction earnings in that category and a proportionate amount of the foreign taxes related to the hovering deficit will be added to the post-1986 foreign income taxes pool. Because the post-transaction earnings in the passive category are half of the amount of the hovering deficit, half of the related taxes are added to the post-1986 foreign income taxes pool. Accordingly, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2009:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	350u		$65	
Passive	50u	(50u)	$30	$5
	400u	(50u)	$95	$5

Example 3. (i) *Facts*. The facts are the same as *Example 2*, except that the 50u of earnings in the passive category accrued by foreign surviving corporation during 2008 is subpart F income, all of which is included in income under section 951(a) by United States shareholders (as defined in section 951(b)). This example assumes that none of the United States shareholders are able to reduce their subpart F income inclusion with a qualified deficit under section 952(c)(1)(B).

(ii) *Result*. (A) Under the rule described in paragraph (f)(1) of this section, the (100u) hovering deficit in the passive category does not reduce foreign surviving corporation's current passive earnings and profits for purposes of determining subpart F income or associated deemed paid credits. Thus, foreign surviving corporation's United States shareholders include their *pro rata* shares of 50u in taxable income for the year and are eligible for a deemed paid foreign tax credit under section 960, computed by reference to their *pro rata* shares of $12.50 (50u subpart F inclusion / (50u + 50u post-1986 undistributed earnings in the passive category = 100u) = 50%, x $25 post-1986 foreign income taxes in the passive category = $12.50). The United States shareholders will also include their *pro rata* shares of the deemed-paid taxes of $12.50 in taxable income for the year as a deemed dividend pursuant to section 78.

(B) Immediately after the subpart F inclusion and section 960 deemed paid taxes (and taking into account the taxable year 2008 earnings and profits and related taxes in the general category), foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	350u		$65.00	
Passive	50u	(100u)	$12.50	$10
	400u	(100u)	$77.50	$10

(C) The 50u included as subpart F income constitutes previously taxed earnings and profits under section 959.

Example 4. (i) *Facts*. (A) On December 31, 2006, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Foreign Corporation A Separate Category	E&P	Foreign Taxes
General	50u	$10

Foreign Corporation B Separate Category	E&P	Foreign Taxes
General	(100u)	$20

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result*. Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	50u	(100u)	$10	$20

(iii) *Post-transaction earnings and distribution*. (A) In its taxable year ending on December 31, 2007, foreign surviving corporation earns 100u in the general category and pays related foreign income taxes of $24. On December 31, 2007, foreign surviving corporation distributes 75u to its shareholders.

(B) *Result*. For purposes of determining the dividend amount under section 316 and the foreign income taxes deemed paid with respect to that dividend under section 902, under paragraph (d)(2)(ii) of this section the hovering deficit does not offset the post-transaction current year earnings. Accordingly, the full 75u will be a dividend under section 316. The deemed paid taxes on that dividend are $17 (75u distribution / (100u current earnings + 50u accumulated earnings) = 50%, x ($10 accumulated foreign taxes + $24 current year foreign taxes) = $17). The 25u of undistributed earnings and profits in 2007 will be offset by (25u) of the hovering deficit for purposes of determining the opening balance of the post-1986 undistributed earnings pool in 2008. Because the amount of earnings offset by the hovering deficit is 25% of the amount of the hovering deficit, under paragraph (d)(2)(iii) of this section $5 (25% of $20) of the related taxes are added to the post-1986 foreign income taxes pool at the beginning of the next taxable year. Accordingly, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2008:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	50u	(75u)	$22	$15

(e) *Pre-pooling annual layers*—(1) *If foreign surviving corporation is a pooling corporation.* If the foreign surviving corporation is a pooling corporation, the pre-pooling annual layers shall be determined under the rules of this paragraph (e)(1).

(i) *Qualifying earnings and taxes.* The pre-pooling annual layers shall consist of the pre-1987 accumulated profits and the pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation.

(ii) *Carryover rule.* Subject to paragraph (e)(1)(iii) of this section, the amounts described in paragraph (e)(1)(i) of this section shall carry over to the foreign surviving corporation but shall not be combined. If the foreign acquiring corporation and the foreign target corporation have pre-1987 accumulated profits in the same year and a distribution is made therefrom, the rules of §1.902–1(b)(2)(ii) and (b)(3) shall apply separately to reduce pre-1987 accumulated profits and pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a *pro rata* basis. For further guidance, see Rev. Rul. 68–351, 1968–2 C.B. 307; Rev. Rul. 70–373, 1970–2 C.B. 152 (see also §601.601(d)(2) of this chapter); see also paragraph (f)(2) of this section (governing the reconciliation of taxable years).

(iii) *Deficit*—(A) *In general.* The rules of this paragraph (e)(1)(iii) apply when, immediately prior to the foreign section 381 transaction, the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in earnings and profits for one or more of the years that comprise its pre-1987 accumulated profits (see also paragraphs (f)(1) and (4) of this section, describing other rules applicable to a deficit described in this paragraph (e)(1)(iii)).

(B) *Aggregate positive pre-1987 accumulated profits.* If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in earnings and profits for one or more years, then the rules otherwise applicable to such deficits shall apply separately to the pre-1987 accumulated profits and related pre-1987 foreign income taxes of such corporation. A deficit in pre-1987 accumulated profits for one or more years is applied to reduce pre-1987 accumulated profits on a LIFO basis. Any remaining deficit shall be applied to reduce pre-1987 accumulated profits in succeeding years. See Rev. Rul. 74–550, 1974–2 C.B. 209 (see also §601.601(d)(2) of this chapter); *Champion Int'l Corp. v. Commissioner*, 81 T.C. 424 (1983), acq. in result, 1987–2 C.B. 1; Rev. Rul. 87–72, 1987–2 C.B. 170 (see also §601.601(d)(2) of this chapter). As a result, no amount in excess of the aggregate positive amount of pre-1987 accumulated profits shall be distributed from the pre-transaction earnings of the foreign acquiring corporation or the foreign target corporation.

(C) *Aggregate deficit in pre-1987 accumulated profits.* If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in pre-1987 accumulated profits, a hovering deficit as defined under paragraph (d)(2)(i) of this section, then the rules under §1.902–2(b) shall apply to such hovering deficit (and related pre-1987 foreign income taxes) immediately prior to the transaction, except that the aggregate hovering deficit that is carried forward into the foreign surviving corporation's post-1986 pool shall offset only post-transaction earnings accumulated by the foreign surviving corporation in the same separate category of post-1986 undistributed earnings to which the relevant portion of the hovering deficit is attributable. Post-transaction earnings do not include earnings and profits that are earned after the foreign section 381 transaction but distributed or deemed distributed in the same year they are earned.

(D) *Deficit and positive separate categories within annual layers.* For purposes of applying the rules of paragraphs (e)(1)(iii)(B) and (C) of this section, if within a single pre-pooling annual layer, the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in pre-1987 accumulated profits in a separate category and positive pre-1987 accumulated profits in another separate category, the deficit shall first be used to offset the positive pre-1987 accumulated profits in the other separate category in the same pre-pooling annual layer. Any remaining deficit shall be carried forward or back to other years according to the rules of paragraph (e)(1)(iii)(B) or (C) of this section as applicable.

(iv) *Pre-1987 section 960 earnings and profits and foreign income taxes.* The pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation but shall not be combined. The rules otherwise applicable to such amounts shall apply separately to the pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a *pro rata* basis. For further guidance, see Notice 88–70, 1988–2 C.B. 369 (see also §601.601(d)(2) of this chapter).

(v) *Examples.* The following examples illustrate the rules of this paragraph (e)(1). The examples assume the following facts: foreign corporation A was incorporated in 2003 and was a nonpooling corporation through December 31, 2004. Foreign corporation A became a CFC on January 1, 2005 and, as a result, began to maintain a pool of post-1986 undistributed earnings on that date. Foreign corporation B was incorporated in 2003 and has always been owned by foreign shareholders (and thus never has met the requirements of section 902(c)(3)(B)). Both foreign corporation A and foreign corporation B have always had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Finally, unless otherwise stated, all earnings and profits of foreign corporations A and B are in the general category. The examples are as follows:

Example 1. (i) *Facts*. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

Foreign Corporation A	E&P	Foreign Taxes
Post-1986 pool	1,000u	$350
2004	400u	160u
2003	100u	5u
	1,500u	

Foreign Corporation B	E&P	Foreign Taxes
2006	100u	20u
2005	150u	30u
2004	0u	50u
2003	50u	5u
	300u	105u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result*. Under the rules described in paragraphs (e)(1)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	E&P	Foreign Taxes
Post-1986 pool	1,000u	$350
2006	100u	20u
2005	150u	30u
Two Side-by-Side Layers of 2004 E&P:		
2004 layer #1 (from Corp A)	400u	160u
2004 layer #2 (from Corp B)	0u	50u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1 (from Corp A)	100u	5u
2003 layer #2 (from Corp B)	50u	5u
	1,800u	

(iii) *Post-transaction distribution*. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,725u to its shareholders. Under the rules of paragraph (c)(1) of this section, the distribution is first out of the post-1986 pool, and then out of the pre-pooling annual layers under the LIFO method, as follows:

	E&P	Foreign Taxes
Post-1986 pool	1,000u	$350
2006	100u	20u
2005	150u	30u
Two Side-by-Side Layers of 2004 E&P:		
2004 layer #1	400u	160u
2004 layer #2	0u	0u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1	50u (100u in layer / 150u aggregate 2003 earnings = 66.67% x 75u distribution)	2.5u
2003 layer #2	25u (50u in layer / 150u aggregate 2003 earnings = 33.33% x 75u distribution)	2.5u
	1,725u	

(B) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	E&P	Foreign Taxes
2004 layer #2	0u	50u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1	50u	2.5u
2003 layer #2	25u	2.5u
	75u	55u

(iv) *Post-transaction earnings*. For the taxable year ending on December 31, 2008, foreign surviving corporation has 500u of current earnings and profits in the general category, none of which qualify as subpart F income under section 952(a), and pays $70 in foreign income taxes. As of the close of the 2008 taxable year, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	E&P	Foreign Taxes
Post-1986 pool	500u	$70
2004	0u	50u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1	50u	2.5u
2003 layer #2	25u	2.5u
	575u	

Example 2. (i) *Facts*. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

Foreign Corporation A	E&P	Foreign Taxes
Post-1986 pool	1,000u	$350
2004	100u	20u
2003	(50u)	5u
	1,050u	
Foreign Corporation B	E&P	Foreign Taxes
2006	100u	20u
2005	(50u)	5u
2004	0u	50u
2003	100u	10u
	150u	85u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result*. Because foreign corporations A and B have aggregate positive amounts of pre-1987 accumulated profits with a deficit in one or more years, the rules of paragraph (e)(1)(iii)(B) of this section apply. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
	Positive E&P	Deficit E&P	Foreign Taxes Available	Foreign Taxes Associated with Deficit E&P
Post-1986 pool	1,000u		$350	
2006	100u		20u	
2005		(50u)		5u
Two Side-by-Side Layers of 2004 E&P:				
2004 layer #1 (from Corp A)	100u		20u	
2004 layer #2 (from Corp B)	0u		50u	
Two Side-by-Side Layers of 2003 E&P:				
2003 layer #1 (from Corp A)		(50u)		5u
2003 layer #2 (from Corp B)	100u		10u	
	1,300u	(100u)		10u

(iii) *Post-transaction distribution*. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,175u to its shareholders. Under the rules described in paragraphs (c)(1) and (e)(1)(iii)(B) of this section, the distribution is first out of the post-1986 pool, and then out of the pre-pooling annual layers, as follows:

Distribution	E&P	Foreign Taxes
Post-1986 pool	1,000u	$350
2006	100u	20u
2005	0u	0u
Two Side-by-Side Layers of 2004 E&P:		
2004 layer #1	50u	20u
2004 layer #2	0u	0u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1	0u	0u
2003 layer #2	25u	5u
	1,175u	

(B) Under paragraph (e)(1)(iii)(B) of this section, the rules otherwise applicable when a foreign corporation has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more years, apply separately to the pre-1987 accumulated profits and related foreign income taxes of foreign corporation A and foreign corporation B. As a result, distributions out of the pre-pooling annual layers of foreign corporation A and foreign corporation B cannot exceed the aggregate positive amount of pre-1987 accumulated profits of each corporation. Accordingly, only 50u can be distributed from foreign corporation A's pre-pooling annual layers and is out of its 2004 layer #1 (after rolling forward the (50u) deficit in 2003 layer #1 to reduce earnings in 2004 layer #1 to 50u (100u - 50u)). Under the principles of §1.902–1(b)(3), the full 20u of taxes related to 2004 layer #1 is reduced or deemed paid ($20 x (50/50)). 100u is distributed from foreign corporation B's 2006 annual layer. Foreign corporation B's (50u) deficit in 2005 is then rolled back to offset its 2003 annual layer to reduce earnings in that layer to 50u, 25u of which is distributed. Thus, after the distribution, 25u remains in 2003 layer # 2 along with 5u of foreign income taxes (10u x (25u / 50u)).

(C) The foreign income taxes deemed paid by qualifying shareholders of foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of sections 78, 902, and 904(d).

(D) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	E&P	Foreign Taxes
2005	0u	5u
2004 layer #2	0u	50u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1	0u	5u
2003 layer #2	25u	5u
	25u	65u

(E) Under paragraph (e)(1)(iii)(B) of this section, the 5u, 50u, and 5u of pre-1987 foreign income taxes related to foreign surviving corporation's 2005 layer, 2004 layer #2, and 2003 layer #1, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

Example 3. (i) *Facts*. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

Foreign Corporation A	E&P	Foreign Taxes
Post-1986 pool	1,000u	$350
2004	150u	20u
2003	100u	5u
	1,250u	

Foreign Corporation B	E&P	Foreign Taxes
2006	100u	20u
2005	(250u)	5u
2004	0u	50u
2003	100u	10u
	(50u)	85u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result*. (A) Because foreign corporation B has an aggregate hovering deficit in pre-1987 accumulated profits, the rules of paragraph (e)(1)(iii)(C) of this section apply. Accordingly, §1.902–2(b) applies immediately prior to the foreign section 381 transaction, except that the hovering deficit is carried forward into the foreign surviving corporation's post-1986 undistributed earnings pool and will offset only post-transaction earnings accumulated by foreign surviving corporation in the general category. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
Post-1986 pool	1,000u	(50u)	$350	$0
2006	0u		20u	
2005	0u		5u	
Two Side-by-Side Layers of 2004 E&P:				
2004 layer #1 (from Corp A)	150u		20u	
2004 layer #2 (from Corp B)	0u		50u	
Two Side-by-Side Layers of 2003 E&P:				
2003 layer #1 (from Corp A)	100u		5u	
2003 layer #2 (from Corp B)	0u		10u	
	1,250u	(50u)		$0

(B) Under paragraph (e)(1)(iii)(C) of this section, the 20u, 5u, 50u, and 10u of pre-1987 foreign income taxes associated with foreign corporation B's pre-1987 accumulated profits for 2006, 2005, 2004 layer #2, and 2003 layer #2, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

(2) *If foreign surviving corporation is a nonpooling corporation*. If the foreign surviving corporation is a nonpooling corporation, then the pre-pooling annual layers shall be determined under the rules of this paragraph (e)(2).

(i) *Qualifying earnings and taxes*. The pre-pooling annual layers shall consist of the pre-1987 accumulated profits and the pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation. If the foreign acquiring corporation or the foreign target corporation (or both) has post-1986 undistributed earnings or a deficit in post-1986 undistributed earnings, then those earnings or deficits and any related post-1986 foreign income taxes shall be recharacterized as pre-1987 accumulated profits or deficits and pre-1987 foreign income taxes of the foreign acquiring corporation or the foreign target corporation accumulated immediately prior to the foreign section 381 transaction.

(ii) *Carryover rule*. Subject to paragraph (e)(2)(iii) of this section, the amounts described in paragraph (e)(2)(i) of this section shall carry over to the foreign surviving corporation but shall not be combined. If the foreign acquiring corporation and the foreign target corporation have pre-1987 accumulated profits in the same year and a distribution is made therefrom, the principles of §1.902–1(b)(2)(ii) and (3) shall apply separately to reduce pre-1987 accumulated profits and pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a *pro rata* basis. For further guidance, see Rev. Rul. 68–351, 1968–2 C.B. 307; Rev. Rul. 70–373, 1970–2 C.B. 152 (see also §601.601(d)(2) of this chapter); see also paragraph (f)(2) of this section (governing the reconciliation of taxable years).

(iii) *Deficits*—(A) *In general*. The rules of this paragraph (e)(2)(iii) apply when, immediately prior to the foreign section 381 transaction (and after application of the last sentence of paragraph (e)(2)(i) of this section), the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in one or more years that comprise its pre-1987 accumulated profits. See also paragraphs (f)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (e)(2)(iii)).

(B) *Aggregate positive pre-1987 accumulated profits*. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in pre-1987 accumulated profits in one or more years, then the rules otherwise applicable to such deficits shall apply separately to the pre-1987 accumulated profits and related foreign income taxes of such corporation. A deficit in pre-1987 accumulated profits for one or more years is applied to reduce pre-1987 accumulated profits on a LIFO basis. Any remaining deficit shall be applied to reduce pre-1987 accumulated profits in succeeding years. See Rev. Rul. 74–550, 1974–2 C.B. 209 (see also §601.601(d)(2) of this chapter); *Champion Int'l Corp. v. Commissioner*, 81 T.C. 424 (1983), acq. in result, 1987–2 C.B. 1; Rev. Rul. 87–72, 1987–2 C.B. 170 (see also §601.601(d)(2) of this chapter). As a result, no amount in excess of the aggregate positive amount of pre-1987 accumulated profits shall be distributed from the pre-transaction earnings of the foreign acquiring corporation or the foreign target corporation.

(C) *Aggregate deficit in pre-1987 accumulated profits*. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in pre-1987 accumulated profits, a hovering deficit as defined under paragraph (d)(2)(i) of this section, then the rules otherwise applicable to such hovering deficits shall apply separately to the pre-transaction earnings and profits and related taxes of the relevant corporation. See, *e.g.*, sections 316(a) and 381(c)(2)(B). Thus, any hovering deficit shall offset only post-transaction earnings accumulated by the foreign surviving corporation in the same separate category of earnings and profits to which the relevant portion of the hovering deficit is attributable. Post-transaction earnings do not include earnings and profits that are earned after the foreign section 381 transaction but distributed or deemed distributed in the same year they are earned. Following the principles of §1.902–2(b), if there is an aggregate deficit in pre-1987 accumulated profits, any related pre-1987 foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and creates a pre-transaction aggregate positive balance for pre-1987 accumulated profits.

(D) *Deficit and positive separate categories within annual layers*. For purposes of applying the rules of paragraphs (e)(2)(iii)(B) and (C) of this section, if within a single pre-pooling annual layer, the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in pre-1987 accumulated profits in a separate category and positive pre-1987 accumulated profits in another separate category, the deficit shall first be used to offset the positive pre-1987 accumulated profits in the other separate category in the same pre-pooling annual layer. Any remaining deficit shall be carried forward or back to other years according to the rules of paragraph (e)(2)(iii)(B) or (C) as applicable.

(iv) *Pre-1987 section 960 earnings and profits and foreign income taxes*. The pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation but shall not be combined. The rules otherwise applicable to such amounts shall apply separately to the pre-1987 section 960 earnings and profits and pre-1987 section 960 foreign income taxes of the foreign acquiring corporation and the foreign target corporation on a *pro rata* basis. For further guidance, see Notice 88–70, 1988–2 C.B. 369 (see also §601.601(d)(2) of this chapter).

(v) *Examples*. The following examples illustrate the rules of this paragraph (e)(2). The examples assume the following facts: both foreign corporation A and foreign corporation B have always had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency, and 1u = US$1 at all times. Finally, unless otherwise stated, all earnings and profits of foreign corporations A and B are in the general category. The examples are as follows:

Example 1. (i) *Facts*. (A) Foreign corporations A and B both were incorporated in 2003. Nine percent of the voting stock of foreign corporation A is owned by domestic corporate shareholder C. Nine percent of the voting stock of foreign corporation B is owned by domestic corporate shareholder D. Shareholders C and D are unrelated. The remaining 91% of the voting stock of each foreign corporation is owned by unrelated foreign shareholders. Thus, neither corporation meets the requirements of section 902(c)(3)(B). On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

Foreign Corporation A	E&P	Foreign Taxes
2006	500u	350u
2005	400u	300u
2004	400u	160u
2003	100u	5u
	1,400u	815u

Foreign Corporation B	E&P	Foreign Taxes
2006	100u	20u
2005	300u	60u
2004	0u	50u
2003	50u	5u
	450u	135u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) *Result*. Under the rules described in paragraphs (e)(2)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	E&P	Foreign Taxes
Two Side-by-Side Layers of 2006 E&P:		
2006 layer #1 (from Corp A)	500u	350u
2006 layer #2 (from Corp B)	100u	20u
Two Side-by-Side Layers of 2005 E&P:		
2005 layer #1 (from Corp A)	400u	300u
2005 layer #2 (from Corp B)	300u	60u
Two Side-by-Side Layers of 2004 E&P:		
2004 layer #1 (from Corp A)	400u	160u
2004 layer #2 (from Corp B)	0u	50u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1 (from Corp A)	100u	5u
2003 layer #2 (from Corp B)	50u	5u
	1,850u	950u

(iii) *Post-transaction distribution*. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 600u to its shareholders. Under the rules of paragraph (c)(3) of this section, the distribution is out of pre-pooling annual layers under the LIFO method as follows:

	E&P	Foreign Taxes
Two Side-by-Side Layers of 2006 E&P:		
2006 layer #1 (from Corp A)	500u	350u
2006 layer #2 (from Corp B)	100u	20u
	600u	370u

(B) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim deemed paid foreign income taxes under section 902. See §1.902–1(a)(10)(iii).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	E&P	Foreign Taxes
Two Side-by-Side Layers of 2005 E&P:		
2005 layer #1 (from Corp A)	400u	300u
2005 layer #2 (from Corp B)	300u	60u
Two Side-by-Side Layers of 2004 E&P:		
2004 layer #1 (from Corp A)	400u	160u
2004 layer #2 (from Corp B)	0u	50u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1 (from Corp A)	100u	5u
2003 layer #2 (from Corp B)	50u	5u
	1,250u	580u

Example 2. (i) *Facts*. (A) The facts are the same as in *Example 1* (i)(A), except that foreign corporation A met the requirements of section 902(c)(3)(B) on January 1, 2005, when U.S. corporate shareholder C acquired an additional 1% of voting stock for a total ownership interest of 10%; foreign corporation A thereby became a pooling corporation. On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

Foreign Corporation A	E&P	Foreign Taxes
Post-1986 pool	900u	$650
2004	400u	160u
2003	100u	5u
	1,400u	
Foreign Corporation B	E&P	Foreign Taxes
2006	100u	20u
2005	300u	60u
2004	0u	50u
2003	50u	5u
	450u	135u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) *Result*. Under the rules described in paragraphs (e)(2)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	E&P	Foreign Taxes
Two Side-by-Side Layers of 2006 E&P:		
2006 layer #1 (from Corp A's pool)	900u	$650
2006 layer #2 (from Corp B's layer)	100u	20u
2005 (from Corp B):	300u	60u
Two Side-by-Side Layers of 2004 E&P:		
2004 layer #1 (from Corp A)	400u	160u
2004 layer #2 (from Corp B)	0u	50u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1 (from Corp A)	100u	5u
2003 layer #2 (from Corp B)	50u	5u
	1,850u	

(iii) *Subsequent ownership change*. On July 1, 2010, USS (a domestic corporation) acquires 100% of the stock of foreign surviving corporation. Under the rules of paragraph (f)(3) of this section, foreign surviving corporation begins to pool its earnings and profits under section 902(c)(3) as of January 1, 2010. Foreign surviving corporation's earnings and profits and foreign income taxes accrued before January 1, 2010 retain their character as pre-1987 accumulated profits and pre-1987 foreign income taxes.

Example 3. (i) *Facts*. (A) The facts are the same as in *Example 2* (i)(A), except that on December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

Foreign Corporation A	E&P	Foreign Taxes
Post-1986 pool	1,000u	$500
2004	(200u)	10u
2003	400u	5u
	1,200u	
Foreign Corporation B	E&P	Foreign Taxes
2006	300u	20u
2005	(100u)	60u
2004	0u	50u
2003	50u	5u
	250u	135u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) *Result*. Because foreign corporations A and B have aggregate positive amounts of pre-1987 accumulated profits with a deficit in one or more years, the rules of paragraph (e)(2)(iii)(B) of this section apply. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
	Positive E&P	Deficit E&P	Foreign Taxes Available	Foreign Taxes Associated with Deficit E&P
Two Side-by-Side Layers of 2006 E&P:				
2006 layer #1 (from Corp A's pool)	1,000u		$500	
2006 layer #2 (from Corp B's layer)	300u		20u	
2005 (from Corp B)		(100u)		60u
Two Side-by-Side Layers of 2004 E&P:				
2004 layer #1 (from Corp A)		(200u)		10u
2004 layer #2 (from Corp B)	0u		50u	
Two Side-by-Side Layers of 2003 E&P:				
2003 layer #1 (from Corp A)	400u		5u	
2003 layer #2 (from Corp B)	50u		5u	
	1,750u	(300u)		70u

(iii) *Post-transaction distribution*. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 1,300u to its shareholders. Under the rules described in paragraphs (c)(3) and (e)(2)(iii)(B) of this section, the distribution is out of the pre-pooling annual layers, as follows:

	E&P	Foreign Taxes
Two Side-by-Side Layers of 2006 E&P:		
2006 layer #1	1,000u	$500
2006 layer #2	250u	20u
2003 E&P:		
2003 layer #1	50u	1.25u (25% of 5u taxes)
	1,300u	

(B) Under paragraph (e)(2)(iii)(B) of this section, the rules otherwise applicable when a foreign corporation has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more years, apply separately to the pre-1987 accumulated profits and related pre-1987 foreign income taxes of foreign corporation A and foreign corporation B. As a result, distributions out of the pre-pooling annual layers of foreign corporation A and foreign corporation B cannot exceed the aggregate positive amount of pre-1987 accumulated profits of each corporation. Accordingly, only 1,200u and 250u can be distributed out of foreign corporation A's and foreign corporation B's pre-pooling annual layers, respectively. Thus, 1,000u of the distribution is out of foreign corporation A's 2006 layer #1 and 250u is out of foreign corporation B's 2006 layer #2 (after rolling forward (50u) of the deficit in 2005 layer to reduce earnings in 2006 layer #1 to 250u (300u - 50u)). Under the principles of §1.902–1(b)(3), all of the taxes in each of those respective layers are reduced. The remaining 50u is distributed from foreign corporation A's 2003 layer #1 (after rolling back the (200u) deficit in 2004 layer #1 to reduce earnings in 2003 layer #1 to 200u (400u - 200u)). Thus, after the distribution, 150u remains in the 2003 layer #1 along with 3.75u of foreign income taxes (5u x (150u / 200u)).

(C) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim a credit for deemed paid foreign income taxes under section 902. See §1.902–1(a)(10)(iii).

(D) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	E&P	Foreign Taxes
2005	0u	60u
Two Side-by-Side Layers of 2004 E&P:		
2004 layer #1	0u	10u
2004 layer #2	0u	50u
Two Side-by-Side Layers of 2003 E&P:		
2003 layer #1	150u	3.75u
2003 layer #2	0u	5u
	150u	128.75u

(E) Under paragraph (e)(2)(iii)(B) of this section, the 60u, 10u, 50u, and 5u of foreign income taxes related to foreign surviving corporation's 2005 layer, 2004 layer #1, 2004 layer #2, and 2003 layer #2, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

Example 4. (i) *Facts*. (A) The facts are the same as in *Example 2* (i)(A), except that on December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

Foreign Corporation A	E&P	Foreign Taxes
Post-1986 pool	(1,000u)	$20
2004	(200u)	10u
2003	400u	5u
	(800u)	
Foreign Corporation B	E&P	Foreign Taxes
2006	100u	20u
2005	300u	60u
2004	0u	50u
2003	50u	5u
	450u	135u

(B) On January 1, 2007, foreign corporation A acquires the assets of foreign corporation B in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a nonpooling corporation.

(ii) *Result*. Under paragraph (e)(2)(i) of this section, foreign corporation A's post-1986 pool is recharacterized as a 2006 layer of pre-1987 accumulated profits. Because after the foreign section 381 transaction foreign corporation A has an aggregate deficit in pre-1987 accumulated profits, the rules of paragraph (e)(2)(iii)(C) of this section apply and the rules otherwise applicable apply separately to the pre-1987 accumulated profits that carry over to foreign surviving corporation from foreign corporation A. The (800u) aggregate deficit in foreign corporation A's pre-1987 accumulated profits is a hovering deficit that will offset only post-transaction earnings accumulated by foreign surviving corporation in the general category. Accordingly, after the foreign section 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
	Positive E&P	Deficit E&P	Foreign Taxes Available	Foreign Taxes Associated with Deficit E&P
Hovering deficit from Corp A's annual layers		(800u)		0
Two Side-by-Side Layers of 2006 E&P:				
2006 layer #1 (from Corp A's pool)		0u		$20
2006 layer #2 (from Corp B's layer)	100u		20u	
2005 (from Corp B)	300u		60u	
Two Side-by-Side Layers of 2004 E&P:				
2004 layer #1 (from Corp A)		0u		10u
2004 layer #2 (from Corp B)	0u		50u	
Two Side-by-Side Layers of 2003 E&P:				
2003 layer #1 (from Corp A)	0u		5u	
2003 layer #2 (from Corp B)	50u		5u	
	450u	(800u)	140u	

(B) Under paragraph (e)(2)(iii)(C) of this section, the $20, 10u, and 5u of pre-1987 foreign income taxes associated with foreign corporation A's pre-1987 accumulated profits for 2006 layer #1, 2004 layer #1, and 2003 layer #1, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

(iii) *Post-transaction distribution*. (A) During 2007, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2007, foreign surviving corporation distributes 200u to its shareholders. Under the rules described in paragraph (e)(2)(iii)(C) of this section, no distribution can be made out of the pre-1987 accumulated profits of foreign corporation A (and the (800u) aggregate hovering deficit will offset only post-transaction earnings accumulated by foreign surviving corporation). Thus, the distribution is out of pre-pooling annual layers as follows:

	E&P	Foreign Taxes Paid
2006 layer #2	100u	20u
2005	100u	20u
	200u	40u

(B) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits notwithstanding that no shareholders are eligible to claim deemed paid foreign income taxes under section 902. See §1.902–1(a)(10)(iii).

(C) Immediately after the distribution, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
	Positive E&P	Deficit E&P	Foreign Taxes Available	Foreign Taxes Associated with Deficit E&P
Hovering deficit from Corp A's annual layers		(800u)		0
Two Side-by-Side Layers of 2006 E&P:				
2006 layer #1 (from Corp A's pool)		0u		$20
2006 layer #2 (from Corp B's layer)	0u		0u	
2005 (from Corp B)	200u		40u	
Two Side-by-Side Layers of 2004 E&P:				
2004 layer #1 (from Corp A)		0u		10u
2004 layer #2 (from Corp B)	0u		50u	
Two Side-by-Side Layers of 2003 E&P:				
2003 layer #1 (from Corp A)	0u		5u	
2003 layer #2 (from Corp B)	50u		5u	
	250u	(800u)	140u	

(f) *Special rules*—(1) *Treatment of deficit*—(i) *General rule*. Any deficit described in paragraph (d)(2), (e)(1)(iii), or (e)(2)(iii) of this section shall not be taken into account in determining current or accumulated earnings and profits of a foreign surviving corporation other than to offset post-transaction accumulated earnings, as defined in paragraph (d)(2)(ii) of this section, including for purposes of calculating—

(A) The earnings and profits limitation of section 952(c)(1)(A); and

(B) the amount of the foreign surviving corporation's subpart F income as defined in section 952(a).

(ii) *Exceptions*. The rule in paragraph (i) shall not apply for purposes of calculating an earnings and profits limitation under section 952(c)(1)(B) or (C).

(iii) *Examples*. The following examples illustrate the principles of this paragraph (f)(1). The examples assume the following facts: foreign corporation A, incorporated in 2002, is and always has been a wholly owned subsidiary of USP, a domestic corporation. Foreign corporation B, incorporated in 2004, is and always has been a wholly owned subsidiary of foreign corporation A. Both foreign corporation A and foreign corporation B are organized under the laws of foreign country X and have always had a calendar taxable year. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Unless otherwise stated, any earnings and profits or deficit in earnings and profits of foreign corporation A and B in the general category are attributable to subpart F income derived from foreign base company sales income. Foreign corporation C is a wholly owned subsidiary of USP2 and was organized in 2004 under the laws of foreign country Y. Foreign corporation C (and all of its qualified business units as defined in section 989) maintains a "u" functional currency. Earnings and profits of foreign corporation C in the general category are not attributable to subpart F income. The examples are as follows:

Example 1. (i) *Facts*. (A) On December 31, 2007, foreign corporations A and B have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Foreign Corporation A Separate Category	E&P	Foreign Taxes
General	(100u)	$25

Foreign Corporation B Separate Category	E&P	Foreign Taxes
General	0u	$10

(B) On January 1, 2008, foreign corporation B elects under §301.7701–3(c) of this chapter to be disregarded as an entity separate from foreign corporation A. Accordingly, foreign corporation B is deemed to have distributed all its property to foreign corporation A in a liquidation described in section 332.

(ii) *Result*. Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	0u	(100u)	$10	$25

(iii) *Post-transaction earnings and subpart F limitations*. (A) In its taxable year ending on December 31, 2008, foreign surviving corporation A earns 300u of subpart F general category income with respect to which it pays $50 in foreign income taxes. The hovering deficit of (100u) meets the requirements under section 952(c)(1)(B) and therefore is taken into account as a qualified deficit that may be used by USP to offset a portion of its income inclusion related to foreign surviving corporation A's subpart F income of 300u in the 2008 taxable year. Accordingly, USP includes 200u in taxable income for the year and is eligible for a deemed paid foreign tax credit under section 960 of $40 (200u subpart F inclusion / 300 post-1986 undistributed earnings in the general category = 66.67%, x $60 foreign income taxes in the general category = $40). USP will also include the deemed paid foreign taxes of $40 in taxable income for the year as a deemed dividend pursuant to section 78. Though the (100u) hovering deficit of foreign surviving corporation A is taken into account for purposes of limiting USP's subpart F income inclusion under section 952(c)(1)(B), the amount of the hovering deficit is not reduced for purposes of sections 316 and 902 and none of the associated foreign income taxes are included in the post-1986 foreign income taxes pool.

(B) As of January 1, 2009, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	100u	(100u)	$20	$25

(C) The 200u included as subpart F income constitutes previously taxed earnings under section 959.

Example 2. (i) *Facts*. (A) On July 1, 2007, foreign corporation B elects under §301.7701–3(c) of this chapter to be disregarded as an entity separate from foreign corporation A. Accordingly, foreign corporation B is deemed to have distributed all of its property to foreign corporation A in a liquidation described in section 332.

(B) Neither foreign corporation A nor B has any post-1986 undistributed earnings or post-1986 foreign income taxes as of the beginning of the 2007 taxable year. For its short taxable year ending on June 30, 2007, foreign corporation B has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Foreign Corporation B Separate Category	E&P	Foreign Taxes
General	(200u)	$30

(C) For the 2007 taxable year, foreign surviving corporation A earns a total of 200u of subpart F foreign based company sales income in the general category with respect to which it pays $40 in foreign income taxes.

(ii) *Result*. (A) Under paragraph (d)(2) of this section, foreign corporation B's (200u) deficit carries over to foreign surviving corporation A as a hovering deficit. Nevertheless, because it is a deficit of a qualified chain member for a taxable year ending within the 2007 taxable year of foreign surviving corporation A, the (200u) deficit meets the requirements under section 952(c)(1)(C) and therefore may still be taken into account for purposes of limiting foreign surviving corporation A's subpart F income. Accordingly, foreign surviving corporation A's 200u of subpart F income for the 2007 taxable year is fully offset by the (200u) deficit of foreign corporation B, and USP will have no subpart F income inclusion for the 2007 taxable year. The offset under section 952(c)(1)(C) does not result in a reduction of the hovering deficit for purposes of section 316 or section 902. The hovering deficit may not also be taken into account under section 952(c)(1)(B).

(B) Because USP has no subpart F income inclusion, foreign surviving corporation A's subpart F earnings of 200u will accumulate and be added to its post-1986 undistributed earnings as of the beginning of 2008. Under the rules of paragraph (f)(5) of this section, a *pro rata* amount, in this case 50% or 100u, will be deemed to have been accumulated prior to the foreign section 381 transaction and the other 50%, or 100u, will be deemed to have been accumulated after the foreign section 381 transaction. The 100u of post-transaction earnings will be offset by (100u) of the hovering deficit for purposes of determining the opening balance of the post-1986 undistributed earnings pool in 2008. Because the amount of earnings offset by the hovering deficit is 50% of the total amount of the hovering deficit, $15 (50% of $30) of the related taxes are added to the post-1986 foreign income taxes pool as well. The 100u of pre-transaction earnings remain in the post-1986 undistributed earnings pool. Accordingly, foreign surviving corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes on January 1, 2008:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	100u	(100u)	$55	$15

Example 3. (i) *Facts*. (A) On January 1, 2007, foreign corporation B and foreign corporation C have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Foreign Corporation B Separate Category	E&P	Foreign Taxes
General	(100u)	$0

Foreign Corporation C Separate Category	E&P	Foreign Taxes
General	0u	$10

(B) On July 1, 2007, foreign corporation B acquires the assets of foreign corporation C in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation B is a CFC.

(C) During the 2007 taxable year foreign surviving corporation B has a current deficit of (400u) and $60 of related foreign income taxes. During its short taxable year ending on June 30, 2007, foreign corporation C has no additional earnings and pays or accrues no foreign income taxes.

(ii) *Result*. (A) Under the rules of paragraph (f)(5) of this section, a *pro rata* amount, in this case 50% or (200u), of foreign surviving corporation B's (400u) current year deficit for the 2007 taxable year will be deemed to have been accumulated prior to the foreign section 381 transaction and be treated as a hovering deficit. The other 50%, or (200u) of the deficit will be deemed to have been accumulated after the foreign section 381 transaction. The related foreign income taxes of $60 will also be allocated on a similar 50/50 basis.

(B) Under the rules described in paragraphs (d)(1) and (2) of this section, foreign surviving corporation B has the following post-1986 undistributed earnings and post-1986 foreign income taxes as of January 1, 2008:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	(200u)	(300u)	$40	$30

(iii) *Subpart F income limitations*. Even though (200u) of the current year deficit is treated as a hovering deficit, the full (400u) current year deficit in 2007 of foreign surviving corporation B meets the requirements under section 952(c)(1)(C) and therefore is available as a limitation on subpart F income, to the extent foreign corporation A, which wholly owns foreign surviving corporation B, earns any subpart F income in the 2007 taxable year. Any such offset under section 952(c)(1)(C) will have no effect on the earnings and profits and foreign income tax accounts above of foreign surviving corporation B for purposes of sections 316 and 902. Moreover, to the extent the hovering deficit reduces subpart F income under section 952(c)(1)(C), it may not also be taken into account under section 952(c)(1)(B).

(2) *Reconciling taxable years*. If a foreign acquiring corporation and a foreign target corporation had taxable years ending on different dates, then the *pro rata* distribution rules of paragraphs (e)(1)(ii) and (e)(2)(ii) of this section shall apply with respect to the taxable years that end within the same calendar year.

(3) *Post-transaction change of status*. If a foreign surviving corporation that is subject to the rules of paragraph (c)(2) of this section subsequently becomes a pooling corporation (by reason, for example, of a reorganization, liquidation, or change of ownership), then post-1986 undistributed earnings and post-1986 foreign income taxes that were recharacterized as pre-1987 accumulated profits and pre-1987 foreign income taxes, respectively, under paragraph (e)(2)(i) of this section retain their characterization as a pre-pooling annual layer.

(4) *Ordering rule for multiple hovering deficits* —(i) *Rule*. A foreign surviving corporation shall apply the deficit rules of paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section in that order if more than one of such rules applies to the foreign surviving corporation.

(ii) *Example*. The following example illustrates the principles of this paragraph (f)(4). The example assumes the following facts: foreign corporation A has been a pooling corporation since its incorporation on January 1, 1998. Foreign corporation B has been a nonpooling corporation since its incorporation on January 1, 2000. Foreign corporations A and B have always had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. All earnings and profits of foreign corporation B are in the general category.

Finally, unless otherwise stated, any earnings and profits in the passive category resulted from a look-through dividend that was paid by a lower-tier CFC out of earnings accumulated when the CFC was a noncontrolled section 902 corporation and that qualified for the subpart F same-country exception under section 954(c)(3)(A). The example is as follows:

Example—(i) *Facts*. (A) On December 31, 2006, foreign corporations A and B have the following earnings and profits and foreign income taxes:

Foreign Corporation A Post-1986 Pool Separate Category:	E&P	Foreign Taxes
Passive	400u	$160
General	(300u)	$ 25
	100u	$185
Foreign Corporation B	E&P	Foreign Taxes
2006	(300u)	50u
2005	100u	25u
	(200u)	75u

(B) On January 1, 2007, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign section 381 transaction, foreign surviving corporation is a CFC.

(ii) *Result*. Under the rules described in paragraphs (d)(1), (d)(2), (e)(1)(i), (e)(1)(ii), and (e)(1)(iii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes:

	Earnings & Profits:		Foreign Taxes:	
	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
Post-1986 Pool Separate Category				
Passive	400u		$160	
General		(300u)		$25
Carryforward pre-pooling deficit from Corp B		(200u)		0
2006 (from Corp B)	0u		50u	
2005 (from Corp B)	0u		25u	
	400u	(500u)		$25

(iii) *Post-transaction earnings*. (A) In the taxable year ending on December 31, 2007, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

Post-1986 Pool Separate Category:	E&P	Foreign Taxes
Passive	150u	$ 40
General	400u	$ 60
	550u	$100

(B) None of the earnings and profits qualify as subpart F income as defined in section 952(a). Under paragraph (f)(4)(i) of this section, the rules of paragraph (d)(2) of this section apply before the rules of paragraph (e)(1)(iii) of this section. Accordingly, post-transaction earnings in a separate category are first offset by a hovering deficit in the same separate category in the post-1986 pool. Thus, foreign surviving corporation's (300u) deficit in the general category offsets 300u of post-transaction earnings in the general category. After application of paragraph (d)(2) of this section, the (200u) deficit in the general category carried forward from foreign corporation B's pre-pooling aggregate deficit offsets the remaining 100u of post-transaction earnings in the general category. Accordingly, foreign surviving corporation has the following earnings and profits and foreign income taxes at the end of 2007:

	Earnings & Profits:		Foreign Taxes:	
	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
Post-1986 Pool				
Separate Category				
Passive	550u		$200	
General			$85	
Carryforward pre-pooling deficit from Corp B		(100u)		$0
2006 (from Corp B)	0u		50u	
2005 (from Corp B)	0u		25u	
	550u	(100u)		$0

(C) Under paragraph (d)(2)(iii) of this section, all of the $25 of post-1986 foreign income taxes related to the (300u) hovering deficit in the general category is added to the foreign surviving corporation's post-1986 foreign income taxes of $60 in that category (because post-transaction earnings in the general category have exceeded the deficit in that category). Under paragraph (e)(1)(iii)(C) of this section, the 50u and 25u of foreign income taxes associated with foreign corporation B's pre-1987 accumulated profits for 2006 and 2005 remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped. See §1.902–2(b)(2).

(5) *Pro rata rule for earnings and deficits during transaction year*. (i) For purposes of offsetting post-transaction earnings of a foreign surviving corporation under the rules described in paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section, the earnings and profits, and any related foreign income taxes, in each separate category for the taxable year of the foreign surviving corporation in which the transaction occurs shall be deemed to have been accumulated after such transaction in an amount which bears the same ratio to the undistributed earnings and profits of the foreign surviving corporation for such taxable year (computed without regard to any earnings and profits carried over) as the number of days in the taxable year after the date of transaction bears to the total number of days in the taxable year. See, *e.g.*, §1.381(c)(2)–1(a)(7) *Example 2* (illustrating application of this rule with respect to domestic corporations).

(ii) For purposes of determining the amount of pre-transaction deficits described in paragraphs (d)(2), (e)(1)(iii), and (e)(2)(iii) of this section, of a foreign surviving corporation that has a deficit in earnings and profits in any separate category for its taxable year in which the transaction occurs, unless the actual accumulated earnings and profits, or deficit, as of such date can be shown, such pre-transaction deficit, and any related foreign income taxes, shall be deemed to have accumulated in a manner similar to that described in paragraph (f)(5)(i) of this section. See, *e.g.*, §1.381(c)(2)–1(a)(7) *Example 4* (illustrating application of this rule with respect to domestic corporations).

(g) *Effective date*. This section shall apply to section 367(b) transactions that occur on or after November 6, 2006.

Par. 8. Section 1.367(b)–8 is added to read as follows:

§1.367(b)–8 Allocation of earnings and profits and foreign income taxes in certain foreign corporate separations. [Reserved]

Par. 9. Section 1.367(b)–9 is added to read as follows:

§1.367(b)–9 Special rule for F reorganizations and similar transactions.

(a) *Scope*. This section applies to a foreign section 381 transaction (as defined in §1.367(b)–7(a)) either—

(i) That is described in section 368(a)(1)(F); or

(ii) That involves—

(A) At least one foreign corporation that holds no property and has no tax attributes immediately before the transaction, other than a nominal amount of assets (and related tax attributes) to facilitate its organization or preserve its existence as a corporation; and

(B) No more than one foreign corporation that holds more than a nominal amount of property or has more than a nominal amount of tax attributes immediately before the transaction.

(b) *Hovering deficit rules inapplicable*. If a transaction is described in paragraph (a) of this section, a foreign surviving corporation shall succeed to earnings and profits, deficits in earnings and profits, and foreign income taxes without regard to the hovering deficit rules of §1.367(b)–7(d)(2), (e)(1)(iii), and (e)(2)(iii).

(c) *Foreign divisive transactions*. [Reserved]

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

Example 1. (i) *Facts*. (A) Foreign corporation A is and always has been a wholly owned subsidiary of USP, a domestic corporation. Foreign corporation A was incorporated in 1995, and has always had a calendar taxable year. Foreign corporation A (and all of its respective qualified business units as defined in section 989) maintains a "u" functional currency. On December 31, 2006, foreign corporation A has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Separate Category:	E&P	Foreign Taxes
Passive	(1,000u)	$ 5
General	200u	$200
	(800u)	$205

(B) On January 1, 2007, foreign corporation A moves its place of incorporation from Country 1 to Country 2 in a reorganization described in section 368(a)(1)(F).

(ii) *Result*. Under §1.367(b)–7(d), as modified by paragraph (b) of this section, the pre-transaction deficit of foreign corporation A will not hover. Accordingly, foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes immediately after the foreign section 381 transaction:

Separate Category:	E&P	Foreign Taxes
Passive	(1,000u)	$ 5
General	200u	$200
	(800u)	$205

Example 2. (i) *Facts*. (A) Foreign corporations B, C and D are and always have been wholly owned subsidiaries of USP, a domestic corporation. Foreign corporation B was incorporated in 2000 and foreign corporations C and D were incorporated in 2001. Foreign corporation B does not own any significant property and has no earnings and profits or foreign income taxes accounts. Both foreign corporations C and D have always had a calendar taxable year. Foreign corporations C and D (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. On December 31, 2006, foreign corporations C and D have the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Foreign Corporation C Separate Category:	E&P	Foreign Taxes
Passive	(900u)	$ 50
General	(200u)	$100
	1100u	$150
Foreign Corporation D Separate Category:	E&P	Foreign Taxes
Passive	1200u	$400
General	400u	$100
	1600u	$500

(B) On January 1, 2007, USP foreign corporations C and D merge into foreign corporation B in a reorganization described in section 368(a)(1)(A).

(ii) *Result*. Although the merger is a foreign section 381 transaction involving a foreign corporation with no property or tax attributes, paragraph (b) of this section does not apply because more than one foreign corporation with significant tax attributes is involved in the foreign section 381 transaction. Accordingly, under §1.367(b)–7(d), foreign surviving corporation B has the following post-1986 undistributed earnings and post-1986 foreign income taxes immediately after the foreign section 381 transaction:

	Earnings & Profits:		Foreign Taxes:	
Separate Category	Positive E&P	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
General	1200u	(900u)	$400	$ 50
Passive	400u	(200u)	$100	$100
	1600u	(1100u)	$500	$150

(d) *Effective date*. This section shall apply to section 367(b) transactions that occur on or after November 6, 2006.

Par. 10. In §1.381(a)–1, paragraph (c) is revised to read as follows:

§1.381(a)–1 General rule relating to carryovers in certain corporate acquisitions.

* * * * *

(c) *Foreign corporations*. For additional rules involving foreign corporations, see §§1.367(b)–7 through 1.367(b)–9.

* * * * *

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

Approved July 20, 2006.

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

(Filed by the Office of the Federal Register for August 7, 2006, 8:45 a.m., and published in the issue of the Federal Register for August 8, 2006, 71 F.R. 44887)

Section 809.—Reduction in Certain Deductions of Mutual Life Insurance Companies

26 CFR 1.809–9: Computation of the differential earnings rate and the recomputed differential earnings rate.

Mutual life insurance companies; recomputed differential earnings rate. The recomputed differential earnings rate for 2004 is determined for use by mutual life insurance companies to compute their income tax liability for 2005.

Rev. Rul. 2006–45

This revenue ruling contains a determination under § 809 of the Internal Revenue Code of the "recomputed differential earnings rate" for 2004. This rate is used by mutual life insurance companies to calculate their federal income tax liability for taxable years beginning in 2005. Notice 2006–18, 2006–8 I.R.B. 502, contained a tentative determination of this rate.

The Job Creation and Worker Assistance Act of 2002, Pub. L. 107–147, § 611, amended § 809 by adding new paragraph (j). Section 809(j) provides that the differential earnings rate shall be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003. *See* Notice 2002–33, 2002–1 C.B. 989. Subsequently, the Pension Funding Equity Act of 2004, Pub. L. 108–218, § 205, repealed § 809 of the Code for taxable years beginning after December 31, 2004. Therefore, the Internal Revenue Service is required to determine a differential earnings rate for 2004 and a recomputed differential earnings rate for 2004. The differential earnings rate for 2004 was zero. *See* Rev. Rul. 2005–58, 2005–36 I.R.B. 465.

The final determination of the rates is set forth in Table 1.

Rev. Rul. 2006–45 Table 1

Determination of Rates To Be Used For Taxable Years Beginning in 2005

Recomputed Differential earnings rate for 2004	0
Imputed earnings rate for 2004	4.449
Base period stock earnings rate	18.221
Current stock earnings rate for 2004	4.913
Stock earnings rate for 2001	2.354
Stock earnings rate for 2002	-1.876
Stock earnings rate for 2003	14.261
Average mutual earnings rate for 2004	10.450

For additional background concerning the recomputed differential earnings rate, *see* Rev. Rul. 2001–33, 2001–2 C.B. 118.

DRAFTING INFORMATION

The principal author of this revenue ruling is Katherine A. Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Hossofsky at (202) 622–8435 (not a toll-free call).

Section 3402.—Income Tax Collected at Source

26 CFR 31.3402(g)–1: Supplemental wage payments.

T.D. 9276

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 31

Flat Rate Supplemental Wage Withholding

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations amending the regulations that provide for determining the amount of income tax withholding on supplemental wages. These regulations apply to all employers and others making supplemental wage payments to employees. These regulations reflect changes in the law made by the American Jobs Creation Act of 2004.

DATES: *Effective Date:* January 1, 2007.

Applicability Date: These regulations are applicable to payments made on or after January 1, 2007.

FOR FURTHER INFORMATION CONTACT: A. G. Kelley, (202) 622–6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 31 under sections 3401 and 3402 of the Internal Revenue Code (Code). Section 904(b) of the American Jobs Creation Act of 2004 (Public Law 108–357, 118 Stat. 1418) (AJCA) provided for mandatory income tax withholding at the highest rate of income tax in effect under section 1 of the Code to the extent an employee's total supplemental wages paid by the employer exceed $1,000,000 during the calendar year. The AJCA also provided that the supplemental wages paid by other businesses under common control would be taken into account in determining whether the employer has paid $1,000,000 of supplemental wages to an employee in the calendar year. In addition, section 904(a) of the AJCA provided that the rate for purposes of optional flat rate withholding on other supplemental wages (*i.e.*, those supplemental wages not subject to mandatory flat rate withholding at the highest rate of income tax) would remain at 25 percent, but could change if income tax rates change.

Proposed regulations under sections 3401 and 3402 of the Code were published in the **Federal Register** on January 5, 2005 (REG–152945–04, 2005–1 C.B. 484 [70 FR 767]). Written and electronic comments responding to the notice of proposed rulemaking were received. A public hearing was held on June 9, 2005. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision.

Summary of Comments and Explanation of Provisions

The final regulations reflect a balancing of two concerns: (1) in accordance with section 3402(a), procedures for withholding should have the goal of approximating the income tax liability of the employee receiving the wages; and (2) procedures for income tax withholding should not place undue administrative burdens on employers.

Definitions of Regular Wages and Supplemental Wages

The final regulations have adopted the definitions of regular wages and supplemental wages provided in the proposed regulations with certain modifications discussed below. In response to comments on the proposed regulations, the final regulations also allow an employer to treat certain wage payments as regular wages or supplemental wages.

The final regulations, like the proposed regulations, provide that supplemental wages include any wages paid by an employer that are not regular wages. Regular wages are defined as amounts paid by an employer for a payroll period either at a regular hourly rate or in a predetermined fixed amount. Wages that vary from payroll period to payroll period based on factors other than the amount of time worked, such as commissions, tips, and bonuses, are supplemental wages.

The proposed regulations provided that a wage payment could qualify as a supplemental wage payment only if it was paid in addition to regular wages paid to the employee. Many commenters were concerned that the same type of compensation would be classified as regular or supplemental wages depending on whether the compensation was paid in addition to regular wages. Commenters also requested that payments of wages after the termination of employment be treated as supplemental wages if such payments would have been treated as supplemental wages prior to termination. Commenters suggested that characterizing the same type of compensation differently depending upon the circumstances upon which the payment was made unduly complicated payroll administration. Commenters also noted that the proposed regulations did not address the classification of wage payments if the employee received two or more types of payments that would normally be classified as supplemental wages, but received no regular wages.

In response to these comments, the final regulations eliminate the rule that a payment can qualify as supplemental wages only if regular wages have been paid to the employee. Under the final regulations, payments that satisfy the basic definition of supplemental wages (*i.e.*, all wage payments other than regular wage payments) will be supplemental wages regardless of whether the employee has received any regular wages in his or her working career with the employer. For example, if an employee's compensation from an employer consists of only income from the exercise of nonstatutory stock options and noncash fringe benefits, such wages will be supplemental wages for federal income tax withholding purposes. Similarly, if a retiree is receiving payments of nonqualified deferred compensation made by the employer or a rabbi trust, such payments will be supplemental wages regardless of whether the payments are made in addition to regular wage payments during either that calendar year or the employee's entire career with the employer.

Commenters requested more flexibility for employers in determining whether particular types of payments are supplemental wages, such as a facts and circumstances test, or a default determination that amounts are supplemental wages where there is uncertainty regarding the correct classification of wages as regular or supplemental wages. Although the final regulations do not adopt these specific suggestions, the final regulations nonetheless address these concerns in other ways. As described below, the final regulations provide more guidance, compared to the proposed regulations, regarding the proper classification of certain types of payments as regular or supplemental wages. Also, the final regulations provide employers with a number of options regarding the treatment of certain payments that will simplify compliance with the requirement that the employer separately track the payment of supplemental wages prior to reaching the threshold for mandatory flat rate withholding. These features of the final regulations help to minimize uncertainties about the classification of particular wage payments.

Commenters requested guidance on whether a number of specific types of payments were regular wages or supplemental wages, including shift differentials paid to employees on an hourly basis, payments to retirees, sick pay, income from restricted stock awards, income from nonstatutory stock options exercised by former employees or retirees, amounts deferred under a retirement plan pursuant to a salary reduction agreement or a nonqualified deferred compensation plan, post-retirement or post-termination payments of wages that would have been treated as supplemental wages if paid prior to the termination of the employment relationship, and imputed income amounts for health insurance coverage for non-dependents. The final regulations have provided additional examples of supplemental wages and regular wages, including some of the items for which specific advice was requested. Other items that are not specifically included in the final regulations were considered to be either analogous to items covered or specifically covered by applicable rules.

A commenter requested that employers be permitted to treat tips, overtime pay, commissions, third-party sick pay, and taxable fringe benefits as either supplemental wages or regular wages. The commenter indicated that many employers have systems in place that treat such payments as regular wages and wanted to continue with such systems. In addition, the commenter noted that tips are considered to represent a basic part of the compensation of many employees and that a tip credit is permitted against the minimum wage for Fair Labor Standards Act (FLSA) purposes. Also, many employees receiving overtime pay earn such pay each payroll period.

In response to this comment, the final regulations permit employers to treat tips and/or overtime pay as regular wages. To provide employers with more flexibility, any such treatment is not required to be applied uniformly to all employees of the employer.

The final regulations do not allow an employer to treat commissions, third party sick pay paid by agents of the employer, or taxable fringe benefits as anything other than supplemental wages. Commissions may vary considerably from pay period to pay period, have the essential characteristics of supplemental wages, and have historically been characterized in the existing regulations as supplemental wages. A longstanding regulation treats sick pay paid by an agent of the employer as supplemental wages and the final regulations have not amended that regulation in providing a definition of supplemental wages. Also, noncash fringe benefits have been treated as supplemental wages since withholding requirements with respect to noncash fringe benefits were set forth in response to the fringe benefit laws enacted by the Deficit Reduction Act of 1984. See Announcement 85–113, 1985–31 I.R.B. 31. With respect to supplemental wage payments below the threshold for mandatory flat rate withholding, employers may use the aggregate procedure, as described below, in determining the amount of withholding to produce similar withholding amounts as if the payments were classified as regular wages.

Procedures for Withholding on Supplemental Wages

These regulations also interpret provisions of the AJCA relating to the taxation of supplemental wages.

Procedures for Withholding on Supplemental Wages of $1,000,000 or Less During a Calendar Year

The final regulations continue to provide that, if an employee has not received cumulatively more than $1,000,000 of supplemental wages during the calendar year, generally there are two procedures available to an employer in withholding on a payment of supplemental wages: (1) the aggregate procedure and (2) optional flat rate withholding. Under the aggregate procedure, employers calculate the amount of withholding due by aggregating the amount of supplemental wages with the regular wages paid for the current payroll period or for the most recent payroll period of the year of the payment, and treating the aggregate as if it were a single wage payment for the regular payroll period.

Optional flat rate withholding on supplemental wages (of $1,000,000 or less cumulatively) allows employers to disregard the amount of regular wages paid to an employee as well as the withholding allowances claimed by an employee on Form W–4, "*Employee's Withholding Allowance Certificate*," and use a flat percentage rate specified in the regulations in calculating the amount of withholding. The final regulations, like existing regulations and revenue rulings, continue to provide that optional flat rate withholding on supplemental wages is generally available only if (1) the employer has withheld income tax from regular wages paid the employee, and (2) the supplemental wages are either (a) not paid concurrently with regular wages or (b) separately stated on the payroll records of the employer.

Commenters requested that employers be allowed to use optional flat rate withholding with respect to such payments to a former employee even if no other payments of wages were being made to the employee during that calendar year. Commenters believed that the requirement that income tax must have been withheld from the regular wages of the employee was unduly restrictive and noted that employers may have difficulty in obtaining Forms W–4 from individuals who were no longer employees.

However, eliminating the requirement that income tax must have been withheld from regular wages paid to the employee in order for optional flat rate withholding to be available to the employer would exacerbate the problem of overwithholding on wages paid to employees. Therefore, the final regulations have retained the rule that income tax must have been withheld from the regular wages of the employee in order for optional flat rate withholding to be available to employers. The final regulations clarify that the income tax withholding requirement will be satisfied if income tax has been withheld from regular wages paid during the same year as the payment of supplemental wages or during the preceding calendar year. The final regulations continue to provide that if the supplemental wage payment is paid under the conditions permitting the use of optional flat rate withholding, the decision whether to use optional flat rate withholding rather than the aggregate procedure is discretionary with the employer.

Procedures for Withholding on Supplemental Wages in Excess of $1,000,000 Paid to One Employee in One Calendar Year

The AJCA established different withholding rules for supplemental wages in excess of $1,000,000 received by an employee from an employer during a calendar year. The AJCA provided that, effective January 1, 2005, employers must withhold from supplemental wages in excess of $1,000,000 at the highest income tax rate under section 1 of the Code.

The final regulations provide that if the sum of a supplemental wage payment and all other supplemental wage payments paid by an employer to an employee during the calendar year exceeds $1,000,000, the withholding rate on the supplemental wages in excess of $1,000,000 shall be equal to the maximum rate of tax in effect under section 1 for taxable years beginning in such calendar year. The maximum rate of tax in effect for taxable years beginning in 2005 is 35 percent. Thus, the mandatory flat rate for supplemental wages in excess of $1 million in a given taxable year is 35 percent and will remain at 35 percent until income tax rates change.[1]

Comments on Method for Withholding on Wages over $1,000,000

Many commenters expressed concern that the mandatory flat rate withholding requirements would force them to identify whether every wage payment was a regular wage or a supplemental wage and to track all supplemental wages paid to determine whether mandatory flat rate withholding applied. Under prior law, treating any wage payment as a supplemental wage was optional for employers, and many employers withheld on supplemental wages under the aggregate procedure and thus were not required to identify whether payments were regular wages or supplemental wages. Commenters were concerned about the cost and burden of implementing a system to track whether payments were regular wages or supplemental wages, especially if only a few employees would have wages subject to mandatory flat rate withholding. While the IRS and Treasury Department appreciate the potential burden created by the need to distinguish between regular and supplemental wages in order to comply with the requirements of section 904(b) of the AJCA, section 904(b) mandates flat rate withholding only for supplemental wages in excess of $1,000,000. The IRS and Treasury Department request additional comments on how any burden could be mitigated while taking into account the scope of section 904(b) and the rules provided in section 3402 of the Code which describe the circumstances under which employees provide withholding exemption certificates, and employers must follow them in implementing withholding. For example, the IRS and Treasury Department are interested in views on whether it should permit employers to withhold at the mandatory flat rate on any amount of total wages (both regular and supplemental) that exceeds $1,000,000.

Special Rules for Determining Applicability of Mandatory Flat Rate Withholding

A commenter also requested that an employer be permitted to treat any supplemental wage payment as subject to mandatory flat rate withholding whenever it is anticipated the employee's supplemental wages for the year are approaching the $1,000,000 threshold. To address these concerns, the final regulations and the revenue procedure provide employers with a number of options in determining whether supplemental wages in excess of $1,000,000 have been paid to an employee during the calendar year.

One commenter suggested that guidance was needed as to the calculation of the amount of noncash fringe benefits to be included in supplemental wages for purposes of determining whether the $1,000,000 threshold for mandatory flat rate withholding has been reached. With respect to the determination of the amount of supplemental wages for purposes of the mandatory flat rate withholding, the regulations are not intended to require different calculations of the amount of wages than would normally apply in determining the amount of wages subject to withholding. Thus, currently applicable procedures for the calculation of noncash fringe benefits of an employee (see Announcement 85–113, which provides employers with special accounting rules that they may use to determine the amount of noncash fringe benefits that are wages subject to income tax withholding) will continue to apply in determining the amount of supplemental wages for purposes of the mandatory flat rate withholding. If the noncash fringe benefit amounts are not wages subject to income tax withholding, then they are not included in regular wages or supplemental wages.

A commenter suggested that specific guidance was needed concerning whether disqualifying dispositions of shares of stock acquired pursuant to the exercise of statutory stock options are taken into account as supplemental wages for purposes of determining whether the $1,000,000 threshold has been reached. Such income is not wages subject to federal income tax withholding. The final regulations specifically provide that income from disqualifying dispositions of shares of stock acquired pursuant to the exercise of statutory stock options is not included in supplemental wages.

A commenter also requested that, for purposes of determining whether an employee has received $1,000,000 of supplemental wages, an employer should be allowed to treat amounts included in Box 1 of Form W–2, "*Wage and Tax Statement*" as "wages, tips, other compensation" as supplemental wages. Items reportable in Box 1 of Form W–2 include items that are not subject to income tax withholding. Nevertheless, in the interest of making the rules administrable for employers, the regulations provide that employers can treat such amounts as supplemental wages.

A commenter requested that, in determining whether the employee has received $1,000,000 of supplemental wages, employers should be allowed to take into account the gross amount of a supplemental wage payment including any pretax deductions that are attributable to such supplemental wages. However, pretax deductions, including salary reduction deferrals, are not includible in gross income for the taxable year and are not wages subject to income tax withholding. Therefore, the IRS and Treasury Department have not adopted this proposal.

Mandatory flat rate withholding applies only to the excess of supplemental wages over $1,000,000 received by an employee from an employer, taking into consideration all payments of supplemental wages made by an employer to an employee. Therefore, the new mandatory flat rate withholding on supplemental wages in excess of $1,000,000 can apply to all of a payment or only a portion of the payment.

The proposed regulations provided that if a particular supplemental wage payment results in an employee exceeding the $1,000,000 supplemental wage threshold, mandatory flat rate withholding will apply to the extent that the payment together with other supplemental wage payments previously made to the employee during the year is in excess of $1,000,000. Because this provision could result in an employer having to treat two portions of a single supplemental wage payment

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

under different withholding regimes, commenters requested that employers be permitted to elect to treat the entire amount of the payment that results in supplemental wage payments to the employee exceeding $1,000,000 as subject to mandatory flat rate withholding. Commenters also requested that to avoid having the mandatory flat rate withholding apply only to the portion of a supplemental wage payment that exceeds $1,000,000, employers be allowed to apply the mandatory rate only to payments after the payment which causes the employee to have received $1,000,000 or more of supplemental wages.

The IRS and Treasury Department concluded this latter approach could not be reconciled with the statute. Section 904(b) of the AJCA provides that "if the supplemental wage payment, when added to all such payments previously made by the employer to the employee during the calendar year, exceeds $1,000,000, the rate used with respect to such excess shall be equal to the maximum rate of tax...." Accordingly, the final regulations continue with the rule that, if a supplemental wage payment results in the total supplemental wage payments to the employee from the employer during the calendar year exceeding $1,000,000, the amount of that payment in excess of $1,000,000 (when added to the supplemental wage payments previously made in the calendar year) is subject to mandatory flat rate withholding. The final regulations, however, permit employers to treat the entire amount of the payment that results in the employee receiving total supplemental wages of more than $1,000,000 as subject to mandatory flat rate withholding. This treatment can apply on an employee-by-employee basis.

A commenter requested that guidance be provided as to the calculation of supplemental wages for purposes of determining the applicability of mandatory flat rate withholding in a situation where salary reduction deferral amounts are deferred from either gross regular wage payments or gross supplemental wage payments to the employee. The commenters requested flexibility in allocating such deferrals. However, in order to apply mandatory flat rate withholding on a consistent basis, payments of wages must be correctly identified as either regular wages or supplemental wages. Therefore, the final regulations provide that, in determining the amount of supplemental wages paid, salary deferral amounts are allocated to the gross regular wage payments or to the gross supplemental wage payments from which they are actually deducted. For example, if an employee had a valid salary reduction agreement deferring 10 percent of all salary and bonuses, and the employee had received wage payments based on $1,500,000 of gross salary and $1,000,000 of gross bonuses prior to reduction for the deferrals (and no other wages), the employer would allocate $150,000 to the gross regular wage payment and $100,000 to the gross supplemental wage payment. Thus, for purposes of the mandatory flat rate withholding, the example employee has received $900,000 of supplemental wages.

Taking into Account Payments by Agents of Employers in Determining Applicability of Mandatory Flat Rate Withholding

In determining whether the supplemental wages paid by an employer to an employee in a given taxable year exceed $1,000,000, the proposed regulations provided that an employer (the first employer) must consider wage payments made to the employee by any other person treated as a single employer with the first employer under section 52(a) or 52(b). Furthermore, if an employer enlists a third party to make a payment to an employee on the employer's behalf, the payment will be considered as made by the employer even though it may have been delivered to the employee by the third party.

Commenters expressed the view that employers should not be required to count supplemental wage payments made by third party agents in determining whether the $1,000,000 supplemental wage threshold has been met. Although the AJCA did not specifically address whether supplemental wage payments made by employers through agents must be considered in determining the applicability of mandatory flat rate withholding, requiring that such wages be taken into account is consistent with the purpose of the legislation to impose income tax withholding on a basis that is more consistent with income tax liability. Failure to consider payments made by agents of an employer would create an inconsistency in the application of mandatory flat rate withholding based on the type of payment systems that employers choose to put in place. Thus, the final regulations retain the rule of the proposed regulations requiring that payments made by agents of the employers must be considered in determining the applicability of mandatory flat rate withholding (with the exception of certain payments discussed below).

A commenter requested that common law employers be allowed to disregard payments made by agents if the payments would be unlikely to trigger the mandatory flat rate withholding. The commenter noted the administrative burden imposed if a third party agent were required to coordinate every payment with the employer to determine whether the employee has received $1,000,000 of supplemental wages. The commenter requested that agents be allowed to presume that mandatory flat rate withholding does not apply until year-to-date payments that they themselves make to a particular worker exceed $100,000. Also, the commenter requested that employers be allowed to presume that the mandatory flat rate withholding does not apply until year-to-date payments that the employer makes to a particular worker, without regard to payments made by a third party payer, exceed $500,000.

In order to provide relief with respect to payments made by agents, the final regulations provide a *de minimis* rule exception. An agent making total wage payments, including regular and supplemental wages, of less than $100,000 to an individual in any calendar year may disregard other supplemental wages from the common law employer or any other agent of the employer that would subject the employee to mandatory flat rate withholding. Similarly, an employer may disregard supplemental wage payments made by an agent to an employee in determining whether the employee has reached the $1,000,000 threshold if the agent has made total wage payments of less than $100,000 to the employee during the calendar year. If an agent does reach the $100,000 threshold of wages paid to a single employee in a calendar year, then the employer, in determining the applicability of mandatory flat rate withholding, must take into account all supplemental wages paid by the agent in determining whether mandatory flat rate withholding applies to a wage payment made after the agent reaches the

$100,000 threshold. Similarly, with the payment that reaches the $100,000 threshold, the agent who has made $100,000 of wage payments to an employee during a calendar year, is required to take into account all wages paid by the employer and any other agent of the employer who has reached the $100,000 threshold in determining the applicability of mandatory flat rate withholding. This *de minimis* rule is subject to an anti-abuse rule, in that it does not apply to the employer in situations where the employer has created an arrangement or arrangements with five or more agents if a principal effect of the arrangement or arrangements is to reduce applicable mandatory flat rate withholding with respect to an employee. Application of the *de minimis* rule is optional. An employer may take into account all supplemental wages paid by agents, regardless of how small the payments are from any particular agent, in determining whether the employee has received $1,000,000 of supplemental wages during the calendar year. Similarly, an agent is not required to apply the *de minimis* rule.

Rates Applicable for Purposes of Optional Flat Rate Withholding

The final regulations change the optional flat rate withholding on supplemental wages to provide that the 20 percent rate applies only to supplemental wages paid prior to January 1, 1994. The rate of 28 percent applies to supplemental wages paid after December 31, 1993, and on or before August 6, 2001. The Revenue Reconciliation Act of 1993, as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, provides that the supplemental withholding rate shall not be less than the third lowest rate of tax applicable under section 1(c) of the Code for wages paid after August 6, 2001, and before January 1, 2005. Consistent with this amendment, the regulations provide that the rate of 27.5 percent applies to supplemental wages paid after August 6, 2001, and on or before December 31, 2001, the rate of 27 percent applies to wages paid after December 31, 2001, and on or before May 27, 2003, and the rate of 25 percent applies to wages paid after May 27, 2003, and on or before December 31, 2004.

One commenter suggested that optional flat rate withholding for wages paid after December 31, 2002, and on or before May 27, 2003, should be 25 percent. The law in effect at the time as enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 provided that the supplemental withholding rate "shall not be less than the third lowest rate of tax applicable under section 1(c) of the Internal Revenue Code of 1986." The commenter stated that the optional flat rate withholding should be 25 percent because the Jobs and Growth Tax Relief Reconciliation Act of 2003 provided that the third lowest rate of tax under section 1(c) of the Code after December 31, 2002, would be 25 percent. However, this provision changing the third lowest rate of income tax rate to 25 percent was not enacted into law until May 28, 2003. Thus, at the time of payments of supplemental wages made after December 31, 2002, and prior to May 28, 2003, the third lowest rate of tax under section 1(c) was 27 percent. As noted in the preamble to the proposed regulations, the IRS and Treasury Department believe that the 27 percent rate for this period is consistent with the general principle that the employment taxation of wage payments is determined based on the rates in effect at the date the wages are paid. *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001). Therefore, the final regulations continue to provide that the optional flat rate withholding for wages paid after December 31, 2002, and prior to May 28, 2003, was 27 percent.

For 2006, the optional flat rate withholding for supplemental wages of $1,000,000 or less in a given taxable year is 25 percent. The optional flat rate withholding will remain at 25 percent until income tax rates change.[2]

Application of Mandatory Flat Rate Withholding Regardless of Employee's Personal Income Tax Liability

Commenters requested that the final regulations provide an exception from mandatory flat rate withholding when the employee receiving the supplemental wage amount will be eligible to take an offsetting income tax credit or an offsetting income tax deduction, but no exception from the definition of wages for income tax withholding purposes applies. Commenters noted that some foreign countries impose foreign income tax but not foreign income tax withholding on supplemental wage payments made to United States employees who are based in and working in those foreign countries. If an employer is not required by foreign law to withhold foreign income tax from a supplemental wage payment, the exception from wages provided by section 3401(a)(8)(A)(ii) of the Code does not apply. However, the payment may be subject to foreign income tax and the employee may be eligible for a foreign income tax credit that could offset any liability for United States income tax. The commenters requested that the regulations provide an exception for United States residents or citizens who are working overseas and receive supplemental wage payments that are subject to foreign income tax, but not foreign income tax withholding.

Another commenter noted that an employee may be required by the terms of a divorce decree to pay the entire amount of a bonus to a former spouse and may be eligible to take an alimony deduction with respect to the transfer to the former spouse. This commenter suggested that the IRS and Treasury Department create an administrative exception from mandatory flat rate withholding that would apply if the employee submits a Form W–4 establishing that the employee will be entitled to an offsetting income tax deduction with respect to the supplemental wage payment.

In enacting the requirement for mandatory flat rate withholding, Congress made clear its intent to override the withholding that would apply pursuant to the employee's elections on the Form W–4 with withholding at a specific statutorily prescribed rate. To provide exceptions for tax credits or deductions that an employee would expect to receive would require the employer to give the employee's Form W–4 or some other document from the employee precedence over the statutory mandate. Moreover, although the com-

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

menters are suggesting limiting the exceptions to circumstances in which specific credible claims for credits or deductions can be made, implementation of such proposals would require the employer to vet claims made by individual employees about their tax circumstances. The IRS and Treasury Department decline to adopt the suggestions made by the commenters because they are contrary to statutory intent and would require the employer to assume a role in assessing employees' tax circumstances that employers cannot and should not be asked to perform.

Effective Date of Regulations

Many commenters stated that making the changes to their payroll systems necessary to comply with mandatory flat rate withholding would take time and require testing. Of particular concern was the coordination of payments by agents. In response to these comments, the final regulations will be effective with respect to wages paid on or after January 1, 2007. This will give employers time to implement any programming and coordination required by the final regulations.

A commenter also asked for permanent relief from mandatory flat rate withholding and related reporting and withholding penalties and interest if the employer (or third party payer) makes reasonable, good faith efforts to comply with the new requirements. Because Congress established this withholding as mandatory, it would be inconsistent with the statute to provide permanent relief from liability for the mandatory flat rate withholding.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply, and therefore, a Regulatory Flexibility Analysis is not required. 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 the impact on small business.

Drafting Information

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

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 31 is amended as follows:

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

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

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

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

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

§31.3401(a)–1 Wages

* * * * *

(b) * * *

(8) * * *

(i) * * *

(*b*) * * *

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

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

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

* * * * *

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

* * * * *

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

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

The revisions and addition read as follows:

§31.3402(g)–1 Supplemental wage payments.

(a) *In general and withholding on supplemental wages in excess of $1,000,000*—(1) *Determination of supplemental wages and regular wages*—(i) *Supplemental wages*. An employee's remuneration may consist of regular wages and supplemental wages. Supplemental wages are all wages paid by an employer that are not regular wages. Supplemental wages include wage payments made without regard to an employee's payroll period, but also may include payments made for a payroll period. Examples of wage payments that are included in supplemental wages include reported tips (except as provided in paragraph (a)(1)(v) of this section), overtime pay (except as provided in paragraph (a)(1)(iv) of this section), bonuses, back pay, commissions, wages paid under reimbursement or other expense allowance arrangements, nonqualified deferred compensation includible in wages, wages paid as noncash fringe benefits, sick pay paid by a third party as an agent of the employer, amounts that are includible in gross income under section 409A, income recognized on the exercise of a nonstatutory stock option, wages from imputed income for health coverage for a non-dependent, and wage income recognized on the lapse of a restriction on restricted property transferred from an employer to an employee. Amounts that are described as supplemental wages in this definition are supplemental wages regardless of whether the employer has paid the employee any regular wages during either the calendar year of the payment or any prior calendar year. Thus, for example, if the only wages that an employer has ever paid an employee are payments of noncash fringe benefits and income recognized on the exercise of a nonstatutory stock option, such payments are classified as supplemental wages.

(ii) *Regular wages*. As distinguished from supplemental wages, regular wages are amounts that are paid at a regular hourly, daily, or similar periodic rate (and not an overtime rate) for the current payroll period or at a predetermined fixed determinable amount for the current payroll period. Thus, among other things, wages that vary from payroll period to payroll period (such as commissions, reported tips, bonuses, or overtime pay) are not regular wages, except that an employer may treat tips as regular wages under paragraph (a)(1)(v) of this section and an employer may treat overtime pay as regular wages under paragraph (a)(1)(iv) of this section.

(iii) *Amounts that are not wages subject to income tax withholding*. If an amount of remuneration is not wages subject to income tax withholding, it is neither regular wages nor supplemental wages. Thus, for example, income from the disqualifying dispositions of shares of stock acquired pursuant to the exercise of statutory stock options, as described in section 421(b), is not included in regular wages or supplemental wages.

(iv) *Optional treatment of overtime pay as regular wages*. Employers may treat overtime pay as regular wages rather than supplemental wages. For this purpose, *overtime pay* is defined as any pay required to be paid pursuant to federal (Fair Labor Standards Act), state, or local governmental laws at a rate higher than the normal wage rate of the employee because the employee has worked hours in excess of the number of hours deemed to constitute a normal work week or work day.

(v) *Optional treatment of tips as regular wages*. Employers may treat tips as regular wages rather than supplemental wages. For this purpose, tips are defined as including all tips which are reported to the employer pursuant to section 6053.

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

(2) *Mandatory flat rate withholding*. If a supplemental wage payment, when added to all supplemental wage payments previously made by one employer (as defined in paragraph (a)(3) of this section) to an employee during the calendar year, exceeds $1,000,000, the rate used in determining the amount of withholding on the excess (including any excess which is a portion of a supplemental wage payment) shall be equal to the highest rate of tax applicable under section 1 for such taxable years beginning in such calendar year. This flat rate shall be applied without regard to whether income tax has been withheld from the employee's regular wages, without allowance for the number of withholding allowances claimed by the employee on Form W–4, "*Employee's Withholding Allowance Certificate*," without regard to whether the employee has claimed exempt status on Form W–4, without regard to whether the employee has requested additional withholding on Form W–4, and without regard to the withholding method used by the employer. Withholding under this paragraph (a)(2) is mandatory flat rate withholding.

(3) *Certain persons treated as one employer*—(i) *Persons under common control*. For purposes of paragraph (a)(2) of this section, all persons treated as a single employer under subsection (a) or (b) of section 52 shall be treated as one employer.

(ii) *Agents*. For purposes of paragraph (a)(2) of this section, any payment made to an employee by a third party acting as an agent for the employer (regardless of whether such person shall have been designated as an agent pursuant to section 3504) shall be considered as made by the employer except as provided in paragraph (a)(4)(iii) of this section.

(4) *Treatment of certain items in determining applicability of mandatory flat rate withholding*—(i) *Optional treatment of compensation not subject to income tax withholding*. For purposes of paragraph (a)(2) of this section, employers may determine whether an employee has received $1,000,000 of supplemental wages during a calendar year by including in supplemental wages amounts includible in income but not subject to withholding that are reported as wages, tips, other compensation on Form W–2.

(ii) *Allocation of salary reduction deferrals*. In allocating salary reduction deferral amounts excludable from wages for purposes of determining whether the employer has paid $1,000,000 of supplemental wages under paragraph (a)(2) of this section, employers must allocate such salary reduction deferral amounts to the type of compensation (*i.e.*, gross amounts of regular wage payments or gross amounts of supplemental wage payments) actually being deferred.

(iii) *Optional de minimis exception for certain payments by agents*. For purposes of paragraph (a)(2) of this section, if an agent makes total wage payments (including regular wages and supplemental wages) of less than $100,000 to an individual during any calendar year, an employer or other agent may disregard such payments in determining whether the individual has received $1,000,000 of supplemental wages during the calendar year, and such agent need not consider whether the individual has received other supplemental wages in determining the amount of income tax to be withheld from the payments. An employer may not avail itself of this exception if the employer is making payments to the employee using five or more agents and a principal effect of such use of agents is to reduce the applicability of mandatory flat rate withholding to the employee. For purposes of paragraph (a)(2) of this section, if an agent makes total wage payments of $100,000 or more to an individual during any calendar year, the entire amount of supplemental wages paid by the agent during the calendar year to the employee must be taken into account (by other agents of the employer that make total wage payments to the employee of $100,000 or more, by the agent, and by the employer for which the agent is acting) in determining whether the employee has received $1,000,000 of supplemental wages.

(iv) *Treatment of supplemental wage payment exceeding $1,000,000 cumulative threshold*. In the case of a supplemental wage payment that, when added to all supplemental wage payments previously made by the employer to the employee in the calendar year, results in the employee having received in excess of $1,000,000 supplemental wages for the calendar year, the employer is required to impose withholding under paragraph (a)(2) of this section only on the portion of the payment that is in excess of $1,000,000 (taking into account all prior supplemental wage payments during the year). However, an employer may subject the entire amount of such supplemental wage payment to the withholding imposed by paragraph (a)(2) of this section.

(5) *Withholding on supplemental wages that are not subject to mandatory flat rate withholding*. To the extent that paragraph (a)(2) of this section does not apply to a supplemental wage payment (or a portion of a payment), the amount of the tax required to be withheld on the supplemental wages when paid shall be determined under the rules provided in paragraphs (a)(6) and (7) of this section.

(6) *Aggregate procedure for withholding on supplemental wages*—(i) *Applicability*. The employer is required to determine withholding upon supplemental wages under this paragraph (a)(6) if paragraph (a)(2) of this section does not apply to the payment or portion of the payment and if paragraph (a)(7) of this section may not be used with respect to the payment. In addition, employers have the option of using this paragraph (a)(6) to calculate withholding with respect to a supplemental wage payment, if paragraph (a)(2) of this section does not apply to the payment, but if paragraph (a)(7) of this section could be used with respect to the payment.

(ii) *Procedure*. Provided this procedure applies under paragraph (a)(6)(i) of this section, the supplemental wages, if paid concurrently with wages for a payroll period, are aggregated with the wages paid for such payroll period. If not paid concurrently, the supplemental wages are aggregated with the wages paid or to be paid within the same calendar year for the last preceding payroll period or for the current payroll period, if any. The amount of tax to be withheld is determined as if the aggregate of the supplemental wages and the regular wages constituted a single wage payment for the regular payroll period. The withholding method used by the employer with respect to regular wages would then be used to calculate the withholding on this single wage payment and the employer would take into consideration the Form W–4 submitted by the employee. This procedure is the aggregate procedure for withholding on supplemental wages.

(7) *Optional flat rate withholding on supplemental wages*—(i) *Applicability*. The employer may determine withholding upon supplemental wages under this paragraph (a)(7) if three conditions are met—

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

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

(C) Income tax has been withheld from regular wages of the employee during the calendar year of the payment or the preceding calendar year.

(ii) *Procedure*. The determination of the tax to be withheld under paragraph (a)(7)(iii) of this section is made without reference to any payment of regular wages, without allowance for the number of withholding allowances claimed by the employee on Form W–4, and without regard to whether the employee has requested additional withholding on Form W–4. Withholding under this procedure is optional flat rate withholding.

(iii) *Rate applicable for purposes of optional flat rate withholding*. Provided the conditions of paragraph (a)(7)(i) of this section have been met, the employer may determine the tax to be withheld—

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

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

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

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

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

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

(8) *Examples*. For purposes of these examples, it is assumed that the rate for purposes of mandatory flat rate withholding for 2007 is 35 percent, and the rate for purposes of optional flat rate withholding for 2007 is 25 percent. The following examples illustrate this paragraph (a):

Example 1. (i) Employee A is an employee of three entities (X, Y, and Z) that are treated as a single employer under section 52(a) or (b). In 2007, X pays regular wages to A on a monthly payroll period for services performed for X, Y, and Z. The regular wages are paid on the third business day of each month. Income tax is withheld from the regular wages of A during the year. A receives only the following supplemental wage payments during 2007 in addition to the regular wages paid by X—

(A) A bonus of $600,000 from X on March 15, 2007;

(B) A bonus of $2,300,000 from Y on November 15, 2007; and

(C) A bonus of $10,000 from Z on December 31, 2007.

(ii) In this *Example 1*, the $600,000 bonus from X is a supplemental wage payment. The withholding on the $600,000 payment from X could be determined under either paragraph (a)(6) or (7) of this section because income tax has been withheld from the regular wages of A. If X elects to use the aggregate procedure under paragraph (a)(6) of this section, the amount of withholding on the supplemental wages would be based on aggregating the supplemental wages and the regular wages paid by X either for the current or last payroll period and treating the total of the regular wages paid by X and the $600,000 supplemental wages as a single wage payment for a regular payroll period. The withholding method used by the employer with respect to regular wages would then be used to calculate the withholding on this single wage payment, and the employer would take into consideration the Form W–4 furnished by the employee.

(iii) In this *Example 1*, the $2,300,000 bonus from Y is a supplemental wage payment. To calculate the withholding on the $2,300,000 supplemental wage payment from Y, the $600,000 of supplemental wages X has already paid to A in 2007 must be taken into account because X and Y are treated as the same employer under section 52(a) or (b). Thus, the withholding on the first $400,000 of the payment (*i.e.*, the cumulative supplemental wages not in excess of $1,000,000) is computed separately from the withholding on the remaining $1,900,000 of the payment (*i.e.*, the amount of the cumulative supplemental wages in excess of $1,000,000). With respect to the first $400,000, the withholding could be computed under either paragraph (a)(6) or (a)(7) of this section, because income tax has been withheld from the regular wages of the employee. If Y elected to withhold income tax using paragraph (a)(7) of this section, Y would withhold on the $400,000 component at 25 percent (pursuant to paragraph (a)(7)(ii)(F) of this section), which would result in $100,000 tax withheld. The remaining $1,900,000 of the bonus would be subject to mandatory flat rate withholding at the maximum rate of tax in effect under section 1 for 2007 (35%) without regard to the Form W–4 submitted by A. The amount withheld from the $1,900,000 would be $665,000. The withholding on the first component and the withholding on the second component then would be added together to determine the total income tax withholding on the supplemental wage payment from Y. Alternatively, under paragraph (a)(4)(iv) of this section, Y could treat the entire $2,300,000 bonus payment as subject to mandatory flat rate withholding at the maximum rate of tax (35%), in which case the amount to be withheld would be 35 percent of $2,300,000, or $805,000.

(iv) The $10,000 bonus paid from Z is also a supplemental wage payment. To calculate the withholding on the $10,000 bonus, the $2,900,000 in cumulative supplemental wages already paid to A in 2007 by X and Y must be taken into account because X, Y, and Z are treated as a single employer. The entire $10,000 bonus would be subject to mandatory flat rate withholding at the maximum rate of tax in effect under section 1 for 2007. The income tax required to be withheld on this payment would be 35 percent of $10,000 or $3,500.

Example 2. Employees B and C work for employer M. Each employee receives a monthly salary of $3,000 in 2007. As a result of the withholding allowances claimed by B, there has been no income tax withholding on the regular wages M pays to B during either 2007 or 2006. In contrast, M has withheld income tax from regular wages M pays to C during 2007. Together with the monthly salary check paid in December 2007 to each employee, M includes a bonus of $2,000, which is the only supplemental wage payment each employee receives from M in 2007. The bonuses are separately stated on the payroll records of M. Because M has withheld no income tax from B's regular wages during either the calendar year of the $2,000 bonus or the preceding calendar year, M cannot use optional flat rate withholding provided under paragraph (a)(7) of this section to calculate the income tax withholding on B's $2,000 bonus. Consequently, M must use the aggregate procedure set forth in paragraph (a)(6) of this section to calculate the income tax withholding due on the $2,000 bonus to B. With respect to the bonus paid to C, M has the option of using either the aggregate procedure provided under paragraph (a)(6) of this section or the optional flat rate withholding provided under paragraph (a)(7) of this section to calculate the income tax withholding due.

Example 3. (i) Employee D works as an employee of Corporation R. Corporations R and T are treated as a single employer under section 52(a) or (b). R makes regular wage payments to Employee D of $200,000 on a monthly basis in 2007, and income tax is withheld from those wages. R pays D a bonus for his services as an employee equal to $3,000,000 on June 30, 2007. Unrelated company U pays D sick pay as an agent of the employer R and such sick pay is supplemental wages pursuant to §31.3401(a)–1(b)(2). U pays D $50,000 of sick pay on October 31, 2007. Corporation T decides to award bonuses to all employees of R and T, and pays a bonus of $100,000 to D on December 31, 2007. D received no other payments from R, T, or U.

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

(A) June 30, 2007 — $3,000,000 (bonus from R);

(B) October 31, 2007 — $50,000 (sick pay from U); and

(C) December 31, 2007 — $100,000 (bonus from T).

(iii) In this *Example 3*, each payment of wages other than the regular monthly wage payments from R is considered to be supplemental wages for purposes of withholding under paragraph (a)(2) of this section. The amount of regular wages from R is irrelevant in determining when mandatory flat rate withholding on supplemental wages must be applied.

(iv) Because income tax has been withheld on D's regular wages, income tax may be withheld on $1,000,000 of the $3,000,000 bonus paid on June 30, 2007, under either paragraph (a)(6) or (7) of this section. If R elects to use optional flat rate withholding provided under paragraph (a)(7)(ii)(F) of this section, withholding would be calculated at 25 percent of the $1,000,000 portion of the payment and would be $250,000.

(v) Income tax withheld on the following supplemental wage payments (or portion of a payment) as follows is required to be calculated at the maximum rate in effect under section 1, or 35 percent in 2007—

(A) $2,000,000 of the $3,000,000 bonus paid by R on June 30, 2007; and

(B) all of the $100,000 bonus paid by T on December 31, 2007.

(vi) Pursuant to paragraph (a)(4)(iii) of this section, because the total wage payments made by U, an agent of the employer, to D are less than $100,000, U is permitted to determine the amount of income tax to be withheld without regard to other supplemental wage payments made to the employee. Income tax withholding on the $50,000 in sick pay may be determined under either paragraph (a)(6) or (7) of this section. If U elects to withhold income tax at the flat rate provided under paragraph (a)(7)(ii)(F) of this section, withholding on the $50,000 of sick pay would be calculated at 25 percent of the $50,000 payment and would be $12,500. Alternatively, U may choose to take account of the $3,000,000 in supplemental wages paid by the employer during 2007 prior to payment of the $50,000 sick pay, and withholding on the $50,000 of sick pay could be calculated applying the mandatory flat rate of 35 percent, resulting in withholding of $17,500 on the $50,000 payment.

Example 4. (i) Employer J has decided it wants to grant its employee B a $1,000,000 net bonus (after withholding) to be paid in 2007. Employer J has withheld income tax from the regular wages of the employee. Employer J has made no other supplemental wage payments to B during the year. The rate for mandatory flat rate withholding in effect in the year in which the payment is made is 35 percent, and the rate for optional flat rate withholding in effect is 25 percent.

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

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

(10) *Alternative methods*. The Secretary may provide by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter) for alternative withholding methods that will allow an employer to meet its responsibility for the mandatory flat rate withholding required by paragraph (a)(2) of this section.

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

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

* * * * *

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

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

(a) * * *

(2) Section 3402(j) and this section are not applicable with respect to wages paid

to the employee that are subject to withholding under §31.3402(g)–1(a)(2). * * *

* * * * *

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

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

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

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

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

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

(c) *Rules about withholding exemption certificates*. For rules relating to invalid withholding exemption certificates, see §31.3402(f)(2)–1(e), and for rules relating to disregarding certain withholding exemption certificates on which an employee claims a complete exemption from withholding, see §31.3402(f)(2)–1T(g).

(d) *Examples*. The following examples illustrate this section:

Example 1. Employee A, an unmarried, calendar-year basis taxpayer, files his income tax return for 2005 on April 10, 2006. A has adjusted gross income of $5,000 and is not liable for any income tax. He had $180 of income tax withheld during 2005. A anticipates that his gross income for 2006 will be approximately the same amount, and that he will not incur income tax liability for that year. On April 20, 2006, A commences employment and furnishes his employer a withholding exemption certificate certifying that he incurred no liability for income tax imposed under subtitle A for 2005, and that he anticipates that he will incur no liability for income tax imposed under subtitle A for 2006. A's employer shall not deduct and withhold on payments of wages made to A on or after April 20, 2006. Under §31.3402(f)(4)–2(c), unless A furnishes a new withholding exemption certificate certifying the statements described in paragraph (a) of this section to his employer, his employer is required to deduct and withhold upon payments of wages to A made after February 15, 2007.

Example 2. Assume the facts are the same as in *Example 1* except that A had been employed by his employer prior to April 20, 2006, and had furnished his employer a withholding exemption certificate prior to furnishing the withholding exemption certificate certifying the statements described in paragraph (a) of this section on April 20, 2006. Under section 3402(f)(3)(B)(i), his employer would be required to give effect to the new withholding exemption certificate no later than the beginning of the first payroll period ending (or the first payment of wages made without regard to a payroll period) on or after May 20, 2006. However, under section 3402(f)(3)(B)(ii), his employer could, if it chose, make the new withholding exemption certificate effective with respect to any payment of wages made on or after April 20, 2006, and before the effective date mandated by section 3402(f)(3)(B)(i). Under §31.3402(f)(4)–2(c), unless A furnishes a new withholding exemption certificate certifying the statements described in paragraph (a) of this section to his employer, his employer is required to deduct and withhold upon payments of wages to A made after February 15, 2007.

Example 3. Assume the facts are the same as in *Example 1* except that for 2005 A has taxable income of $8,000, income tax liability of $839, and income tax withheld of $1,195. Although A received a refund of $356 due to income tax withholding of $1,195, he may not certify on his withholding exemption certificate that he incurred no liability for income tax imposed by subtitle A for 2005.

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

Approved July 14, 2006.

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

(Filed by the Office of the Federal Register on July 24, 2006, 8:45 a.m., and published in the issue of the Federal Register for July 25, 2006, 71 F.R. 42049)

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.702: Publication, public inspection, and specific requests for records.
(Also: Part I, Section 6103(p)(2).)

Rev. Proc. 2006–35

SECTION 1. PURPOSE

The purpose of this revenue procedure is to announce new user fees that will be charged by the Internal Revenue Service to process Form 8802, *Application for United States Residency Certification*. The user fee will be charged for all Form 8802 applications submitted with a postmark date on or after October 2, 2006. The rules for these user fees are set forth below and will be incorporated in the next revision of Form 8802 and accompanying instructions.

SECTION 2. BACKGROUND

Form 8802 is used to request Form 6166, a letter that the applicant may use as proof of the applicant's status as a resident of the United States to claim benefits under an income tax treaty or an exemption from a value added tax (VAT) imposed by a foreign country. Applicants that are fiscally transparent for U.S. federal tax purposes, such as partnerships, S corporations and grantor trusts, may request certification based on the status of their partners, shareholders, owners or beneficiaries. Custodians must submit a separate Form 8802 on behalf of each account holder.

An applicant may request Form 6166 for multiple countries and multiple tax periods on a single Form 8802 application. Form 8802 requires the applicant, among other requirements, to specify the country or countries for which certification is requested, the number of Form(s) 6166 to be issued for each country, the tax period(s) for which certification is requested, as well as the applicant's taxpayer identification number (TIN) and, in the case of applicants that are fiscally transparent entities, the TINs of the applicant's partners, shareholders, owners or beneficiaries. See Form 8802 and instructions for additional information on the application process.

SECTION 3. PROCEDURES

.01 Requests to which a user fee applies

The user fee charge will apply to process all Form 8802 applications submitted with a postmark date on or after October 2, 2006. A user fee of $35.00 per Form 8802 submitted will cover a request for up to 20 original Forms 6166 issued under a single TIN, regardless of the number of countries for which certification is requested or the tax period(s) to which the certification applies. An additional $5.00 will cover a request on the same Form 8802 for up to 20 additional Forms 6166 issued under the same TIN. Additional requests for Form 6166 submitted on a separate Form 8802 will require the payment of a new $35.00 user fee charge. Applicants are thus advised to include all Form 6166 requests on a single Form 8802 to avoid a new $35.00 user fee charge for processing a second Form 8802 application.

For example, if you request on Form 8802:

Number of Form 6166	*User Fee*
1–20	$35.00
21–40	$40.00
41–60	$45.00
61–80	$50.00

Examples of applicable user fees:

(1) Requests by custodians. A custodian requesting certification on behalf of an account holder will be charged a user fee for each account holder based on the number of Forms 6166 requested for that person.

(2) Requests by partnerships or other fiscally transparent entities with multiple partners, owners or beneficiaries. A partnership, S corporation, grantor trust or other fiscally transparent entity will be charged a user fee based on the number of Forms 6166 issued under its employer identification number (EIN), notwithstanding that the Internal Revenue Service will verify the tax status of each of the partners, owners or beneficiaries of the entity who have consented to certification in the name of the partnership, S corporation, grantor trust or other fiscally transparent entity.

.02 Method of payment

Each application must be accompanied by a check or money order payable to the United States Treasury in U.S. dollars. Applicants should not send cash.

.03 Effect of nonpayment or payment of insufficient amount

If Form 8802 is received and payment has not been made or the payment was made for less than the correct amount, the U.S. residency certification unit will contact the applicant or the applicant's authorized representative and give a reasonable amount of time to submit the proper user fee. The applicant's Form 8802 will not be processed until proper payment has been received.

.04 Refunds of user fee

(1) Refunds will not be issued in the following situations:

(a) Form 8802 is procedurally deficient and the applicant fails to submit in a timely manner the additional information necessary to complete the application for processing as requested;

(b) Form 8802 is withdrawn at any time subsequent to its receipt.

(2) Refunds may be issued in the following situation:

Taking into account all the facts and circumstances, including the Internal Revenue Service's resources devoted to the request, the responsible Accounts Management Director in his or her sole discretion decides a refund is appropriate.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for Form 8802 applications received with a postmark date on or after October 2, 2006.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Quyen P. Huynh of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Ms. Huynh at (202) 622–3880 (not a toll-free call); for information regarding processing of Form 8802 and the user fees, contact Mr. Robert Hergenhan of Wage and Investment, Customer Account Service, Accounts Management at (215) 516–6685 (not a toll-free call).

Part IV. Items of General Interest

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

Announcement 2006-57

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

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

Consent Suspensions From Practice Before the Internal Revenue Service

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

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

Name	Address	Designation	Date of Suspension
Crane, Stephen	Palm Springs, CA	Enrolled Agent	May 4, 2006 to August 3, 2007
Cohen, Ronald J.	Newburgh, NY	Attorney	Indefinite from June 21, 2006
Layson, David A.	Corydon, IN	Attorney	April 7, 2006 to October 6, 2007
Brough, Donald L.	Salem, IN	CPA	July 1, 2006 to June 30, 2010
Gulian, Yervant	Great Neck, NY	CPA	April 17, 2006 to December 16, 2007

Name	Address	Designation	Date of Suspension
Rivera-Smith, Dawn	Brick, NJ	CPA	May 30, 2006 to November 29, 2008
Eckstein, Matthew	Woodbury, NY	CPA	June 15, 2006 to March 14, 2007
Hecht, Jodee L.	Clifton, VA	CPA	Indefinite from June 19, 2006
Finch, Phillip W.	Yorktown, VA	CPA	Indefinite from June 22, 2006
Troese Jr., Henry A.	Clarion, PA	Enrolled Agent	Indefinite from June 22, 2006
Robbins, Ronald E.	Pittsford, VT	CPA	June 24, 2006 to June 23, 2008
Shapiro, Sidney C.	West Palm Beach, FL	CPA	Indefinite from July 1, 2006
Martini, Anthony	Stamford, CT	CPA	June 18, 2006 to December, 17, 2007
Cunningham, William	Philadelphia, PA	CPA	July 1, 2006 to March 31, 2007
Simontacchi, Joseph F.	Morris Plains, NJ	CPA	Indefinite from July 1, 2006
Carroccio, Ronald P.	Staten Island, NY	CPA	Indefinite from July 1, 2006
Miller, Walter P.	Roanoke, VA	CPA	Indefinite from July 1, 2006
Aneji, Patrick	Houston, TX	CPA	Indefinite from June 22, 2006
Rosenbloom, Mark L.	Chicago, IL	Attorney	August 15, 2006 to August 14, 2007
Viener, Ira S.	Fort Lee, NJ	CPA	Indefinite from August 1, 2006

Name	Address	Designation	Date of Suspension
Ganz, Sheldon M.	Great Neck, NJ	CPA	Indefinite from August 1, 2006
Tomasulo, Maria	Wantagh, NY	CPA	Indefinite from August 7, 2006
Galpern, Joel G.	North Miami, FL	CPA	Indefinite from September 1, 2006

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
Dolan Jr., John L.	Memphis, TN	Attorney	Indefinite from April 3, 2006
St. Mary, Randall L.	Snohomish, WA	Attorney	Indefinite from April 3, 2006
Theriault, Michael J.	Bel Air, MD	Attorney	Indefinite from April 3, 2006
Smith, Bernard P.	Marblehead, MA	Attorney	Indefinite from April 3, 2006
Bradley, Phillip M.	West Point, VA	Attorney	Indefinite from April 3, 2006
Haefele, Richard J.	Wayzata, MN	Attorney	Indefinite from April 3, 2006
Decker, William E.	Mandeville, LA	Attorney	Indefinite from April 3, 2006
Arbour, John J.	Monroe, LA	Attorney	Indefinite from April 3, 2006

Name	Address	Designation	Date of Suspension
Keller, John S.	Martin Kenner, LA	Attorney	Indefinite from April 3, 2006
Fallon, Charles D.	Neptune, NJ	Attorney	Indefinite from April 3, 2006
Agresti, Thomas J.	Centennial, CO	Attorney	Indefinite from April 3, 2006
Kirsch, Craig F.	Pittsburgh, PA	CPA	Indefinite from April 3, 2006
Hall, Lenny G.	McDowell, KY	CPA	Indefinite from April 11, 2006
Hultgren, Jerry R.	Fresno, CA	Attorney	Indefinite from April 11, 2006
Loutos, Peter A.	Chicago, IL	Attorney	Indefinite from April 11, 2006
Smith III, Frank L.	Bushnell, FL	Attorney	Indefinite from April 11, 2006
Morley, Michael J.	Springfield, PA	CPA	Indefinite from April 11, 2006
Waters, Richard W.	Smithfield, UT	CPA	Indefinite from April 11, 2006
Hartgraves, Travis M.	Abilene, TX	Attorney	Indefinite from April 14, 2006
Dunn, George T.	Lockhart, TX	Attorney	Indefinite from April 14, 2006
Adkins, Thomas R.	Houston, TX	Attorney	Indefinite from April 14, 2006
Hairston, John W.	Sugar Land, TX	Attorney	Indefinite from April 26, 2006
Marcone, Frank J.	Upper Providence, PA	Attorney	Indefinite from May 1, 2006

Name	Address	Designation	Date of Suspension
Fraley, Donald J.	Minneapolis, MN	Attorney	Indefinite from May 3, 2006
Tooke, S. Judd	Shreveport, LA	Attorney	Indefinite from May 3, 2006
Reilly, Michael G.	Council Bluffs, IA	Attorney	Indefinite from May 3, 2006
Faneuil, Robert A.	Newton, MA	Attorney	Indefinite from May 3, 2006
Maignan, Peter R.	Upper Marlboro, MD	Attorney	Indefinite from May 3, 2006
Son, David	Phoenix, AZ	Attorney	Indefinite from May 5, 2006
Susman, Warren I.	New York, NY	Attorney	Indefinite from May 8, 2006
Wurst, Jerome	Arlington, TX	Attorney	Indefinite from May 8, 2006
O'Shea, Joseph G.	Jackson Heights, NY	Attorney	Indefinite from May 8, 2006
Biegelson, Alan	Brooklyn, NY	Attorney	Indefinite from May 8, 2006
Leonard, Robert K.	Winston-Salem, NC	Attorney	Indefinite from May 8, 2006
Cassidy, Michael M.	Madison, WI	Attorney	Indefinite from May 8, 2006
Dobkin, Daniel B.	New Hyde Park, NY	Attorney	Indefinite from May 8, 2006
Nealy, Joseph L.	Sugarland, TX	Attorney	Indefinite from May 16, 2006
Conmey, Edwin W.	Oconomowoc, WI	Attorney	Indefinite from May 16, 2006
Knott Jr., Robert T.	Los Angeles, CA	Attorney	Indefinite from May 16, 2006

Name	Address	Designation	Date of Suspension
Diamond, Howard S.	Mendham, NJ	Attorney	Indefinite from May 16, 2006
Fitzgerald, Bill L.	Lubbock, TX	Attorney	Indefinite from May 16, 2006
Brubaker, Gregory A.	San Francisco, CA	Attorney	Indefinite from May 18, 2006
Dodenbier, Robert F.	Lehi, UT	Attorney	Indefinite from May 18, 2006
Young, Paul J.	Taft, CA	Attorney	Indefinite from June 8, 2006
Dahodwala, Fatema	Andover, MA	Attorney	Indefinite from June 8, 2006
Mendola, Joseph E.	Monessen, PA	CPA	Indefinite from June 8, 2006
Rooney, Edward F.	Minneapolis, MN	Attorney	Indefinite from June 8, 2006
Long, Rebecca L.	Wichita, KS	Attorney	Indefinite from June 8, 2006
West, Clifton C.	Fayetteville, NC	Attorney	Indefinite from June 8, 2006
Silva, Zoilo I.	City Island, NY	Attorney	Indefinite from June 8, 2006
Tyler Jr., Earle S.	Bangor, ME	Attorney	Indefinite from June 12, 2006
Horneber, Alice S.	Sioux City, IA	Attorney	Indefinite from June 12, 2006
Donnelly, Christine M.	Blue Springs, MO	Attorney	Indefinite from June 12, 2006
Driscoll Jr., Peter	Columbia, MD	Attorney	Indefinite from June 12, 2006
Souza, John C.	Pocatello, ID	Attorney	Indefinite from June 12, 2006

Name	Address	Designation	Date of Suspension
Crockett, Kevin J.	Midvale, UT	Attorney	Indefinite from June 12, 2006
White, Debra M. Wyatt	Navasota, TX	CPA	Indefinite from June 12, 2006
Wilkins, Daniel J.	Chelmsford, MA	Attorney	Indefinite from June 12, 2006
Merica, Chad L.	Murray, UT	CPA	Indefinite from June 12, 2006
Wintroub, David S.	Omaha, NE	Attorney	Indefinite from June 12, 2006
Smith, Roderick E.	Kansas City, MO	Attorney	Indefinite from June 12, 2006
Guida, Joseph M.	Aberdeen, MD	Attorney	Indefinite from June 12, 2006
Sonibare, Nash	St. Paul, MN	CPA	Indefinite from June 12, 2006
Braun, Marc W.	St. Louis, MO	Attorney	Indefinite from June 12, 2006
Coffey, John J.	Rye, NH	Attorney	Indefinite from June 12, 2006
Whitehead, H. Allen	New York, NY	Attorney	Indefinite from June 12, 2006
Lansky, Sidney	Mattapoisett, MA	Attorney	Indefinite from June 12, 2006
Pazniokas, Paul M.	Norwood, MA	Attorney	Indefinite from June 12, 2006
Bajgrowicz, James J.	Santa Rosa, CA	Attorney	Indefinite from June 12, 2006
Davis, Bret J.	Los Angeles, CA	Attorney	Indefinite from June 12, 2006
McAvoy, Timothy	Chicago, IL	Attorney	Indefinite from June 12, 2006

Name	Address	Designation	Date of Suspension
Loffadelli, Thomas C.	Studio City, CA	Attorney	Indefinite from June 12, 2006
Emeziem, Kelechi C.	Antioch, CA	Attorney	Indefinite from June 12, 2006
Pugh, William C.	Wayzata, MN	Attorney	Indefinite from June 12, 2006
Lamanna, Eugene C.	Reading, PA	Attorney	Indefinite from June 12, 2006
Bartels, John R.	St. Paul, MN	Attorney	Indefinite from June 12, 2006
Shapiro, Kenneth S.	Bala Cynwyd, PA	CPA	Indefinite from June 14, 2006
Stone, Jerry W.	Austin, TX	Attorney	Indefinite from June 21, 2006
Vanriper, Philip E.	Binghamton, NY	Attorney	Indefinite from June 21, 2006
Simuro, Valerie T.	Gardiner, NY	Attorney	Indefinite from June 21, 2006
Simms, William K.	Brooklyn, NY	Attorney	Indefinite from June 21, 2006
Weaver, Terring M.	Clarksburg, WV	CPA	Indefinite from July 1, 2006
Norman, Clarence	Brooklyn, NY	Attorney	Indefinite from August 3, 2006
Knight, John G.	Winston-Salem, NC	Attorney	Indefinite from August 3, 2006
Kronegold, Sheldon H.	Englewood, NJ	Attorney	Indefinite from August 3, 2006
Foushee, Wayne H.	Winston-Salem, NC	Attorney	Indefinite from August 3, 2006

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 administrative law judge, the following individuals have been placed under suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Kahn, Harold	Hollis, NY	CPA	June 26, 2006 to June 25, 2010

Disbarments 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 administrative law judge, the following individuals have been disbarred from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Gailey, James N.	Huntersville, NC	CPA	June 5, 2006

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
Williams, Daniel S.	Carlsbad, CA	Attorney	March 29, 2006
Azan, Reinaldo L.	Miami Beach, FL	CPA	July 24, 2006
Golub, Stephen B.	Norwalk, CT	CPA	August 3, 2006

The 2006 Version of Form 8830, Enhanced Oil Recovery Credit, Will Not Be Issued

Announcement 2006–62

This announcement is to advise that Form 8830, *Enhanced Oil Recovery Credit,* will not be issued for 2006 because the credit is phased out for 2006.

The enhanced oil recovery credit is equal to 15% of the taxpayer's qualified enhanced oil recovery costs for the tax year, but phased-out as crude oil prices increase. The applicable crude oil prices have increased sufficiently for the credit to be phased-out entirely for 2006.

However, 2006 calendar year taxpayers may still be entitled to the credit as a result of having it passed through to them from fiscal year partnerships (other than electing large partnerships) or S corporations whose tax year began in 2005. In such a case, the partnership or S corporation will provide the taxpayer the necessary information to report the credit on the 2006 Form 3800, *General Business Credit.*

Overview of the IRS's Use of Private Collection Agencies (PCAs) in 2006

Announcement 2006–63

Section 881 of the American Jobs Creation Act, Pub. L. No. 108–357, enacted new section 6306 of the Internal Revenue Code (the Code), which authorizes the Internal Revenue Service to enter into contracts with private collection agencies (PCAs) to assist in the collection of delinquent Federal tax liabilities. Shortly, three PCAs will begin to assist the IRS with the collection of Federal tax debts pursuant to section 6306. This announcement describes certain aspects of the IRS's contracts with PCAs, IRS monitoring of PCA compliance with these provisions, and protections for taxpayers whose accounts are being assigned to PCAs for collection activity.

THE ROLE OF PRIVATE COLLECTION AGENCIES

Code section 6306 limits the role of PCAs to three specific functions:

- Locating and contacting taxpayers specified by the IRS concerning tax debts specified by the IRS;
- Requesting payment of specified taxes in a lump sum or, for taxpayers who cannot pay all at once, by installment agreement providing for full payment over a period of not more than five years; and
- Obtaining taxpayer financial information specified by the IRS.

In addition, the IRS has further refined the role of PCAs. To be eligible for an installment agreement, a taxpayer must file all required Federal tax returns. PCAs will request that the taxpayer provide information regarding tax return filing compliance. To verify the accuracy of the taxpayer's responses regarding whether the taxpayer has filed all returns, the PCAs must confirm the information with the IRS. Only IRS employees will have access to IRS records to investigate the issue.

Although the IRS retains the right to approve or reject any installment agreement negotiated between PCAs and taxpayers, PCAs must obtain specific IRS approval of any installment agreement involving payment of more than $25,000 or covering a period of more than 36 months. During evaluation of payment arrangements, the PCA may request taxpayer financial information that will be forwarded to the IRS. PCAs are not authorized to negotiate installment agreements for periods exceeding 60 months or that provide for less than full payment of the taxpayer's liability. In such cases, PCAs will serve only to gather financial information for transmittal to the IRS.

Subject to certain limited exceptions, PCAs are restricted from contacting third parties during the course of their work on behalf of the IRS. In the course of their efforts to locate or obtain financial information about a taxpayer, PCAs may access non-IRS computer databases or web sites. PCA employees are not permitted to call or write any third party, such as the taxpayer's employer, bank, or neighbors, to ask about the taxpayer's financial condition. PCA employees may speak to intermediaries, such as a taxpayer's spouse, or leave a message on an answering machine, for purposes of trying to contact the taxpayer by phone. Once the PCA knows how to reach a taxpayer directly, a PCA employee may not contact third parties in an effort to reach the taxpayer at a different temporary location.

PCA EMPLOYEES MUST SAFEGUARD TAXPAYER INFORMATION

PCA employees may be given certain tax return information necessary to perform services for the IRS. PCA employees are prohibited by Code section 6103 from disclosing the tax return information they receive from the IRS or from taxpayers to the same extent as are IRS employees. PCA employees are also prohibited from gaining access to tax return information that is not necessary to the performance of their duties. If PCA employees violate their obligation to keep tax return information confidential or if they gain access to tax return information that is not necessary to the performance of their duties under the contract with the IRS, the PCA employees may be subject to criminal prosecution under Code section 7213 or 7213A. The taxpayer whose return information was improperly disclosed may also have a civil cause of action under Code section 7431.

The IRS will not provide PCAs with copies of a taxpayer's filed returns or with access to any information the IRS has concerning the taxpayer that is not necessary for PCA employees to perform their jobs. When the IRS refers a taxpayer's account to a PCA, the information the IRS will provide to PCAs includes:

- The taxpayer's name and social security number (or taxpayer identification number);
- If the taxpayer's spouse jointly owes the tax liability, the name and social security number of the spouse;
- The taxpayer's last known address;
- The tax year and amount of the assigned debt, and the date when the statute of limitations for collection expires; and
- The name, address, telephone number, and authority level of any person the taxpayer has given a power of attorney or taxpayer information authorization.

If a taxpayer requests an installment agreement and the PCA has been informed that the taxpayer has not filed all required returns, PCA employees will advise the taxpayer to file any delinquent returns and make any payments to a designated IRS address, rather than to the PCA. If a taxpayer mistakenly sends a return or payment to the PCA, the PCA will immediately transmit the return or payment to the IRS.

After a PCA's contract with the IRS concludes, or after a particular taxpayer's account is recalled from a PCA by the IRS, the PCA may retain any records it has concerning the taxpayer only for the limited time periods specified in the PCA's contract with the IRS. A PCA and its employees are strictly prohibited from using any information obtained about a taxpayer in the course of working on the contract with the IRS for any purpose other than working on the contract.

If a taxpayer disputes the existence of a debt with the IRS or the amount of the taxpayer's prior payments on a debt the IRS has referred to a PCA, the PCA will refer that dispute to the IRS for resolution. If the IRS determines that the existence and amount of the debt is accurate and provides the taxpayer with appropriate verification of the debt, the PCA will continue to work the account.

PCA EMPLOYEES MUST RESPECT ALL TAXPAYER RIGHTS

The law which enables the IRS to use PCAs also provides explicit protections of taxpayer rights by PCAs, including:

- PCAs and their employees are required by Code section 6306(b)(2) to observe all of the Internal Revenue Code's protections for taxpayer rights in the collection process to the same extent as IRS employees;
- PCAs may be sued by the taxpayer under Code section 7433A and may be liable for damages if they fail to observe all of the Internal Revenue Code's protections for taxpayer rights in the collection process;
- PCAs and their employees must obey all other federal and state restrictions that apply to private debt collectors, pursuant to Code section 6306(e) and 15 U.S.C. section 1692n. Pursuant to Code section 7433A(b)(3), PCAs enjoy no special immunity from being sued while working for the IRS;
- PCAs are specifically obligated to comply with the provisions of the Fair Debt Collection Practices Act, except when those provisions are inconsistent with the Internal Revenue Code, pursuant to Code section 6306(e);
- PCA employees will be disqualified from further work on the IRS contract if they are found to have committed any act of misconduct described in section 1203(b) of the IRS Restructuring and Reform Act of 1998, pursuant to section 881(d) of the American Jobs Creation Act; and
- PCAs are subject to Taxpayer Assistance Orders issued by the National Taxpayer Advocate to the same extent as the IRS, pursuant to Code section 7811(g).

Important taxpayer rights that apply to a PCA's work for the IRS include:

- A PCA's employees may not contact the taxpayer at any unusual time or place, or at a time or place that the PCA should know to be inconvenient, without a taxpayer's prior consent. Generally, no contacts will be made earlier than 8 a.m. or later than 9 p.m. local time at the taxpayer's location, pursuant to Code section 6304(a);
- PCA employees may not suggest or imply to the taxpayer or to any other person that the PCA may be able to initiate enforced tax collection activity (for example, file a lien, issue a levy, make a property seizure, or commence a legal action) or recommend enforced collection action to the IRS, pursuant to the IRS contracts with the PCAs and 15 U.S.C. section 1692e;
- PCA employees may not suggest or imply that the taxpayer's failure to pay the tax debt may affect the taxpayer's credit rating or that the unpaid tax debt may be reported to a credit bureau, pursuant to Code section 6103 and 15 U.S.C. section 1692e; and
- If the taxpayer proposes an installment agreement to the PCA and the IRS rejects the proposed installment agreement, the taxpayer may appeal the rejection to the IRS. If the IRS assigns a PCA to monitor an installment agreement and the PCA determines the taxpayer is in default, the taxpayer may appeal to the IRS if the installment agreement is terminated. In both situations, the taxpayer must first appeal to the IRS office supervising the PCA's day-to-day work, but if not satisfied the taxpayer may continue the appeal to the IRS Office of Appeals, pursuant to the IRS's contracts with the PCAs and the IRS's implementation procedures for Code sections 6159(e) and 7122(d)(1).

WHAT A TAXPAYER SHOULD EXPECT FROM PRIVATE DEBT COLLECTION

After the IRS notifies the taxpayer that the taxpayer has an unpaid Federal tax debt, the IRS may refer the taxpayer's account to a PCA for collection. When the IRS refers an unpaid tax debt to a PCA for collection, the IRS will mail the taxpayer a letter enclosing the new IRS publication, "What You Can Expect When the IRS Assigns Your Account to a Private Collection Agency." The IRS mailing will provide the taxpayer with the PCA's name, address, and telephone number, and will address frequently asked questions on the private debt collection process. The mailing will also include telephone numbers if a taxpayer wants to contact the IRS office overseeing the PCA or the Taxpayer Advocate Service (TAS). The mailing will explain that a taxpayer may request in writing to work with the IRS instead of with a PCA to resolve the outstanding debt.

If a taxpayer requests TAS assistance or describes circumstances meeting TAS criteria to a PCA, the PCA must immediately complete an application for a taxpayer assistance order with the relevant facts and provide the form to an IRS employee who serves as a liaison between the PCA and TAS. Criteria for referring a taxpayer account to TAS include circumstances when a taxpayer has experienced a delay of more than 30 days to resolve a taxpayer account problem with the IRS or when a taxpayer is experiencing or is about to suffer economic harm.

Within ten days after the IRS refers an account, the PCA should send a letter to the taxpayer with copies to the taxpayer's authorized representatives. The letter will introduce the PCA, provide information on the balance due to the IRS, and provide a scannable payment coupon for the taxpayer to make a payment to the IRS. Although the IRS may pay PCAs a fee for their collection efforts, a taxpayer will receive credit for the full amounts paid to the IRS.

The PCA may use techniques approved by the IRS and in compliance with the Fair Debt Collection Practices Act to locate and contact the taxpayer by telephone. A PCA employee will discuss payment options with the taxpayer. If the taxpayer cannot pay in full immediately, the PCA will discuss the option of payment by means of an installment agreement. Some types of installment agreements will require the PCA to obtain financial information from the taxpayer. Although installment payments will be made directly to the IRS, PCAs may be used to monitor a taxpayer's compliance with installment agreements. PCAs are not authorized to discuss offers-in-compromise. PCA employees will direct a taxpayer who wishes to discuss an offer-in-compromise to contact the IRS. Taxpayers who indicate that their financial situations make them unable to pay the amount of the debt may also be referred to the IRS.

IRS MONITORING AND OVERSIGHT

The IRS has created special units of IRS employees to provide monitoring and oversight for all PCA operations on behalf of the IRS. The IRS also has trained key personnel in each PCA concerning taxpayer privacy, other taxpayer rights and IRS procedures, and has provided the PCAs with videos, instructional materials and operational handbooks. Training programs delivered by key personnel with each PCA to other PCA employees, in turn, were reviewed and approved by the IRS. The IRS also carefully reviews and approves standard PCA correspondence, telephone scripts and checklists.

PCAs must keep telephone logs of all incoming and outgoing calls, and must make these logs available to the IRS. The IRS will randomly monitor PCA calls to assure that taxpayers are treated fairly and professionally.

Taxpayers may contact the PCA or the IRS concerning the conduct of any PCA employee. In the event of a complaint about a PCA, the IRS will direct the PCA to suspend collection activity on the account until the PCA and IRS have evaluated the complaint. Each PCA is required to keep a complaint log, accessible to the IRS, including employees of the TAS, and to the Treasury Inspector General for Tax Administration.

CONTACT INFORMATION

For further information regarding this announcement, contact Joyce Peneau at 202–283–0715 (not a toll-free number) or by email at *PDC@irs.gov*.

Section 1248 Attribution Principles; Correction

Announcement 2006–64

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; correction

SUMMARY: This document corrects a notice of proposed rulemaking (REG–135866–02, 2006–27 I.R.B. 34) that was published in the **Federal Register** on Friday, June 2, 2006 (71 FR 31985) providing guidance for determining the earnings and profits attributable to stock of controlled foreign corporations (or former controlled foreign corporations) that are (were) involved in certain nonrecognition transactions.

FOR FURTHER INFORMATION CONTACT: Michael Gilman, (202) 622–3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking (REG–135866–02) that is the subject of this correction is under section 1248 of the Internal Revenue Code.

Need for Correction

As published, REG–135866–02 contains errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the proposed regulations (REG–135866–02) which was the subject of FR. Doc. E6–8551, is corrected as follows:

1. On page 31990, column 1, in the preamble, under the paragraph heading "Explanations of Provisions", following the second full paragraph of the column, the following language is added:
   "*F. Effective Date.*

These regulations are proposed to apply to income inclusions that occur on or after the date that final regulations are published in the **Federal Register**."

2. On page 31990, column 1, in the preamble, under the paragraph heading "Explanations of Provisions", the language "*F. Request for Comments*" is corrected to read "*G. Request for Comments*".

Guy Traynor,
Chief, Publications and Regulations Branch,
Legal Processing Division,
Associate Chief Counsel
(Procedure and Administration).

(Filed by the Office of the Federal Register on August 11, 2006, 8:45 a.m., and published in the issue of the Federal Register for August 14, 2006, 71 F.R. 46415)

Section 1248 Attribution Principles; Correction

Announcement 2006–65

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; correction

SUMMARY: This document corrects a notice of proposed rulemaking (REG–135866–02, 2006–27 I.R.B. 34) that was published in the **Federal Register** on Friday, June 2, 2006 (71 FR 31985) providing guidance for determining the earnings and profits attributable to stock of controlled foreign corporations (or former controlled foreign corporations) that are (were) involved in certain nonrecognition transactions.

FOR FURTHER INFORMATION CONTACT: Michael Gilman, (202) 622–3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking (REG–135866–02) that is the subject of this correction is under section 1248 of the Internal Revenue Code.

Need for Correction

As published, REG–135866–02 contains errors that may prove to be misleading and are in need of clarification.

* * * * *

Correction of Publication

Accordingly, the notice of proposed rulemaking (REG–135866–02) that was the subject of FR Doc. EG–8551 is corrected as follows:

PART 1 — INCOME TAXES

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

Authority: 26 USC 7805 * * *

Par. 2. On page 31991, instructional **Par. 4.** is amended by adding a new entry at the end of the amendatory instruction to read as follows:

6. Adding new paragraph (g).

§1.1248–1 [Corrected]

Par. 3. On page 31991, section 1.1248–1 is amended by adding a new paragraph (g) to read as follows:

§ 1.1248–1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations

* * * * *

(g) *Effective date*. Paragraph (a)(4) and paragraph (a)(5), *Example 4*, of this section apply to income inclusions that occur on or after the date that paragraph and example are published as final regulations in the **Federal Register**.

* * * * *

Guy Traynor,
Chief, Publications and Regulations Branch,
Legal Processing Division,
Associate Chief Counsel
(Procedure and Administration).

(Filed by the Office of the Federal Register on August 11, 2006, 8:45 a.m., and published in the issue of the Federal Register for August 14, 2006, 71 F.R. 46416)

Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions; Correcting Amendment

Announcement 2006–66

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains corrections to final regulations (T.D. 9254, 2006–13 I.R.B. 662) that were published in the **Federal Register** on Tuesday, March 14, 2006 (71 FR 13008) regarding guidance on suspension of losses on certain stock dispositions.

DATES: These corrections are effective March 14, 2006.

FOR FURTHER INFORMATION CONTACT: Theresa Abell (202) 622–7700 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations (T.D. 9254) that are the subject of this correction are under section 1502 of the Internal Revenue Code.

Need for Correction

As published, final regulations (T.D. 9254) contains errors that may prove to be misleading and are in need of clarification.

* * * * *

Correction of Publication

Accordingly, 26 CFR Parts 1 and 602 are corrected by making the following correcting amendments:

PART 1—INCOME TAXES

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

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

§1.1502–35 [Corrected]

Par. 2. Section 1.1502–35 is amended as follows:

1. By revising the text of paragraph (d)(4)(i)(B)(*2*).

2. By revising the text of paragraphs (d)(8) and (d)(9).

3. By revising the text of paragraph (e), *Example 3*., paragraph (v).

4. By revising the text of paragraph (e), *Example 4*., the first sentence of paragraph (iv) and paragraph (v).

5. By revising the text of paragraph (e), *Example 6*., paragraph (i).

6. By revising the text of paragraph (g)(5) *Examples 1*. and *2*, the first sentence of paragraph (i).

7. By revising the text of paragraph (g)(5) *Example 3*, the first three sentences of paragraphs (i) and paragraph (ii).

8. By revising the text of the first sentence of paragraph (j).

§1.1502–35 Transfers of subsidiary stock and deconsolidations of subsidiaries.

* * * * *

(d)

(4) * * *

(i) * * *

(B) * * *

(2) Any liabilities of the subsidiary that have been taken into account for tax purposes.

* * * * *

(8) Higher-tier. A subsidiary is higher-tier with respect to a member if or to the extent investment adjustments under §1.1502–32 with respect to the stock of the latter member would affect investment adjustments with respect to the stock of the former member.

(9) Lower-tier. A subsidiary is lower-tier with respect to a member if or to the extent investment basis adjustments under §1.1502–32 with respect to the stock of the former member would affect investment adjustments with respect to the stock of the latter member.

(e) * * *

Example 3. * * *

(v) *Effect of subsequent stock sale*. P recognizes $0 gain/loss on the Year 6 sale of its remaining S common stock. No amount of suspended loss remains to be allowed under paragraph (c)(5) of this section.

Example 4. * * *

(iv) *Effect of subsequent asset sale on suspended loss*. Because P cannot establish that all or a portion of the loss recognized on the sale of Asset B was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 4 stock sale and such loss is allocable to the period beginning on the date of the Year 4 disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 4 disposition and before the first date on which S2 is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. * * *

(v) *Effect of subsequent stock sale*. In year 6, when S1 sells its remaining S2 stock for $100, it recognizes $0 gain/loss. Pursuant to paragraph (c)(5) of this section, the remaining $5 of the suspended loss is allowed on the P group's return for Year 6 when S1 sells its remaining S2 stock.

* * * * *

Example 6. * * * (i) In Year 1. P forms S with a contribution of $80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 in exchange for 20 shares of common stock of S in a transfer to which section 351 applies. In Year 4, in a transaction that is not part of a plan that includes the Year 1 and Year 2 contributions, P contributes the 20 shares of S common stock it acquired in Year 2 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. Immediately after the contribution to PS, S is a member of the P group. In Year 5, P sells its interest in PS for $20.

* * * * *

(g) * * *

(5) * * *

Example 1. Transfers of property in the avoidance of basis redetermination rule—(i) *Facts*. In Year 1, P forms S with a contribution of $100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. In Year 3, P contributes Asset A with a basis of $50 and a value of $20 to PS in exchange for an additional capital and profits interest in PS in a transaction described in section 721. Also in Year 3, PS contributes Asset A to S and P contributes an additional $80 to S in transfers to which section 351 applies. In Year 4, S sells Asset A for $20, recognizing a loss of $30. The P group uses that loss to offset income of P. In Year 5, P sells its entire interest in PS for $40.

Example 2. Transfers effecting a reimportation of loss—(i) *Facts*. In Year 1, P forms S with a contribution of Asset A with a value of $100 and a basis of $120, Asset B with a value of $50 and a basis of $70, and Asset C with a value of $90 and a basis of $100 in exchange for all of the common stock of S and S becomes a member of the P group. * * *

* * * * *

Example 3. Transfers to avoid recognition of gain—(i) *Facts*. P owns all of the stock of S1 and S2. The S2 stock has a basis of $400 and a value of $500. S1 owns 50% of the S3 common stock with a basis of $150. * * *

(ii) *Analysis*. Pursuant to paragraph (b)(4) of this section, because S2 owns stock of S3 (another subsidiary of the same group) and, immediately after the sale of the S2 stock, S3 is a member of the group, then for purposes of applying paragraph (b) of this section, S2 is deemed to have transferred its S3 stock. Because S3 is a member of the group immediately after the transfer of the S2 stock and the S3 stock deemed transferred has a basis in excess of value, the group in the S3 stock is redetermined pursuant to paragraph (b)(1) of this section immediately prior to the sale of the S2 stock.

Accordingly, P would recognize only $1 of gain on the sale of its S2 stock. However, because the recapitalization of the S3 was structured with a view to, and has the effect of, avoiding the recognition of gain on a disposition of stock by invoking the application of paragraph (b) of this section, paragraph (g)(4)(i) of this section applies. Accordingly, paragraph (b) of this section does not apply upon P's disposition of the S2 stock and P recognizes $100 gain on the disposition of the S2 stock.

* * * * *

(j) *Effective date*. This section applies with respect to stock transfers, deconsolidations of subsidiaries, determinations of worthlessness, and stock dispositions on or after March 10, 2006. * * *

* * * * *

Guy R. Traynor,
Branch Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration).

(Filed by the Office of the Federal Register on August 18, 2006, 8:45 a.m., and published in the issue of the Federal Register for August 21, 2006, 71 F.R. 48473)

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

Announcement 2006–69

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

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

If on the other had a suite for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on September 11, 2006, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Youth Ministries, Inc., d/b/a
Operation Rescue West
Wichita, KS

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

Numerical Finding List[1]

Bulletins 2006–27 through 2006–37

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2006–1 through 2006–26 is in Internal Revenue Bulletin 2006–26, dated June 26, 2006.

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

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