

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

T.D. 9225, page 716.

Final regulations under section 368 of the Code provide guidance regarding the satisfaction of the continuity of interest requirement for corporate reorganizations. Specifically, these regulations identify certain circumstances in which the determination, of whether a proprietary interest in the target corporation is preserved, would be made by reference to the value of the issuing corporation's consideration on the last business day before there is an agreement to effect the potential reorganization.

REG-106030-98, page 739.

Proposed regulations under section 863 of the Code govern the source of income from certain space and ocean activities. It also contains proposed regulations governing the source of income from certain communications activities. The regulations affect persons who derive income from activities conducted in space, or on or under water not within the jurisdiction of a foreign country, possession of the United States, or the United States (in international water). It also affects persons who derive income from transmission of communications. A public hearing is scheduled for December 15, 2005.

Notice 2005-74, page 726.

This notice announces that Treasury and the Internal Revenue Service (IRS) will amend the regulations under section 367(a) of the Code to clarify the application of regulations section 1.367(a)-8, including the provisions addressing the treatment of gain recognition agreements as a result of certain common asset reorganizations involving the U.S. transferor, the transferee foreign corporation, and the transferred corporation.

EXEMPT ORGANIZATIONS

REG-111257-05, page 759.

Proposed regulations clarify the substantive requirements for tax exemption under section 501(c)(3) of the Code. This document also contains provisions that clarify the relationship between the substantive requirements for tax exemption under section 501(c)(3) and the imposition of section 4958 excise taxes.

Announcement 2005-75, page 764.

Alpha Kappa Psi Scholarship Fund, of Minneapolis, MN; Alphabets Childcare Center, Inc., of Clarksville, TN; Inner City Development Foundation, of Los Angeles, CA; and Rocky Road Incorporated, of Snowmass Village, CO, no longer qualify as organizations to which contributions are deductible under section 170 of the Code.

(Continued on the next page)

Announcements of Disbarments and Suspensions begin on page 765.
Finding Lists begin on page ii.



ADMINISTRATIVE

Notice 2005-73, page 723.

This notice summarizes and clarifies the relief previously granted under sections 6081, 6161, 6656, and 7508A of the Code with respect to taxpayers affected by Hurricane Katrina. By news releases issued on August 30, 2005, September 2, 2005, September 8, 2005, and September 14, 2005, the IRS granted relief from filing and payment deadlines, and granted relief from the acts listed in regulations section 301.7508A-1(c)(1) and Rev. Proc. 2005-27, 2005-20 I.R.B. 1050. See IR-2005-84, IR-2005-91, IR-2005-96, and IR-2005-103. The news releases provided that taxpayers affected by the disaster will have until January 3, 2006, to file certain tax returns and submit payments. In addition, the news releases announced that the IRS will abate interest and any late filing or late payment penalties that otherwise would apply. This relief includes the September 15, 2005, due date for estimated taxes and for calendar-year corporate returns with automatic extensions. This notice summarizes the relief previously granted in the news releases.

Rev. Proc. 2005-67, page 729.

Per diem allowances. This procedure provides optional rules for deeming substantiated the amount of certain business expenses of traveling away from home reimbursed to an employee or deductible by an employee or self-employed individual. Rev. Proc. 2005-10 superseded.

Announcement 2005-74, page 764.

This document changes the date of a public hearing on proposed regulations (REG-108524-00, 2005-23 I.R.B. 1209) relating to the circumstances under which a partnership may take partner-level deductions and losses into account in computing its withholding tax obligation with respect to a foreign partner's allocable share of effectively connected taxable income. The public hearing is rescheduled for November 16, 2005.

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.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

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

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62-2: *Reimbursements and other expense allowance arrangements.*

Rules are provided under which a reimbursement or other expense allowance arrangement for the cost of lodging, meal, and incidental expenses, or of meal and incidental expenses, incurred by an employee while traveling away from home will satisfy the requirements of § 62(c) of the Code for substantiation of the amount of the expenses. See Rev. Proc. 2005-67, page 729.

Section 162.—Trade or Business Expenses

26 CFR 1.162-17: *Reporting and substantiation of certain business expenses of employees.*

Rules are provided for substantiating the amount of a deduction for an expense for meal and incidental expenses, or for incidental expenses only, incurred while traveling away from home. See Rev. Proc. 2005-67, page 729.

Section 368.—Definitions Relating to Corporate Reorganizations

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

T.D. 9225

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations that provide guidance regarding the satisfaction of the continuity of interest requirement for corporate reorganizations. The final regulations affect corporations and their shareholders.

DATES: *Effective Date:* These regulations are effective September 16, 2005.

FOR FURTHER INFORMATION CONTACT: Jeffrey B. Fienberg, at (202) 622-7770 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The Internal Revenue Code of 1986 (Code) provides for general nonrecognition treatment for reorganizations described in section 368 of the Code. In addition to complying with the statutory and certain other requirements, to qualify as a reorganization, a transaction generally must satisfy the continuity of interest (COI) requirement. COI requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.

On August 10, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG-129706-04, 2004-2 C.B. 478) in the **Federal Register** (69 FR 48429) (hereinafter the proposed regulations) identifying certain circumstances in which the determination of whether a proprietary interest in the target corporation is preserved would be made by reference to the value of the issuing corporation's stock on the day before there is an agreement to effect the potential reorganization. In particular, in cases in which the consideration to be tendered to the target corporation's shareholders is fixed in a binding contract and includes only stock of the issuing corporation and money, the issuing corporation stock to be exchanged for the proprietary interests in the target corporation would be valued as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization (the signing date rule). Under the proposed regulations, consideration is fixed in a contract if the contract states the number of shares of the issuing corporation and the amount of money, if any, to be exchanged for the proprietary interests in the target corporation. The signing date

rule is based on the principle that, in cases in which a binding contract provides for fixed consideration, the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date.

No public hearing regarding the proposed regulations was requested or held. However, several written and electronic comments regarding the notice of proposed rulemaking were received. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

These final regulations retain the general framework of the proposed regulations but make several modifications in response to the comments received. The following sections describe the most significant comments and the extent to which they have been incorporated into these final regulations.

A. Fixed Consideration

As stated above, the proposed regulations require that the consideration in a contract be fixed in order for the signing date rule to apply. One commentator identified a number of contractual arrangements that do not provide for fixed consideration within the meaning of the proposed regulations, but, nevertheless, are arrangements in which the consideration should be treated as fixed and, therefore, eligible for the signing date rule. In particular, the commentator identified a number of circumstances in which, rather than stating the number of shares and money to be exchanged for target corporation shares, a contract may provide that a certain percentage of target corporation shares will be exchanged for stock of the issuing corporation. One such circumstance is where a merger agreement permits the target corporation some flexibility in issuing its shares between the signing date and effective date of the potential reorganization. Such an issuance may occur, for example, upon the exercise

of employee stock options. As a result, the total number of outstanding target corporation shares at the effective time of the merger and, therefore, the total number of shares of the acquiring corporation to be issued in the merger, may not be known when the merger agreement is signed.

In addition, a contract may permit the target corporation shareholders to elect to receive stock (the number of shares of which may be determined pursuant to a collar) and/or money or other property in respect of target corporation stock, but provide that a particular percentage of target corporation shares will be exchanged for stock of the issuing corporation and a particular percentage of target corporation stock will be exchanged for money. In these cases, if either the stock or the cash consideration is oversubscribed, adjustments are made to the consideration to be tendered in respect of the target corporation shares such that the specified percentage of target corporation shares is, in fact, exchanged for stock of the issuing corporation.

The IRS and Treasury Department agree that a contract that provides for either the percentage of the number of shares of each class of target corporation stock, or the percentage by value of the target corporation shares, to be exchanged for issuing corporation stock should be treated as providing for fixed consideration, as long as the target corporation shares to be exchanged for issuing corporation stock and the target corporation shares to be exchanged for consideration other than issuing corporation stock each represents an economically reasonable exchange. Just as in cases in which the contract states the number of shares of the issuing corporation and the amount of money, if any, to be exchanged for the proprietary interests in the target corporation, in these cases, the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date. Accordingly, these final regulations include an expanded set of circumstances in which a contract will be treated as providing for fixed consideration.

B. Contingent Consideration

The fact that a contract provides for contingent consideration will generally

prevent a contract from being treated as providing for fixed consideration. One commentator suggested that a contract should not be treated as failing to provide for fixed consideration solely because it provides for contingent consideration that can only increase the proportion of issuing corporation stock to cash to be exchanged for target corporation shares. Where stock of the issuing corporation is the only type of consideration that is subject to a contingency, the delivery of any of the contingent consideration to the target corporation shareholders will enhance the preservation of the target corporation's shareholders' proprietary interests. Therefore, these final regulations provide for a limited exception to the general rule that an arrangement that provides for contingent consideration will not be one to which the signing date rule applies. The exception applies to cases in which the contingent consideration consists solely of stock of the issuing corporation and the execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if none of the contingent consideration were delivered to the target corporation shareholders.

The IRS and Treasury Department continue to study whether other arrangements involving contingent consideration should be within the scope of the signing date rule. Among these arrangements are cases in which the contingent consideration consists not only of issuing corporation stock but also of money or other property and cases in which the issuing corporation stock to be issued in respect of target corporation stock is determined pursuant to a collar.

C. Nature of Consideration

As described above, under the proposed regulations, the signing date rule applies only when the consideration to be provided in respect of target corporation shares includes only stock of the issuing corporation and money. One commentator suggested that the signing date rule should be expanded to apply to transactions in which the non-stock consideration includes property other than money. Under these final regulations, the signing date rule may apply in such cases. Therefore, under these

final regulations, the signing date rule may apply, for example, in cases in which proprietary interests in the target corporation are exchanged for stock and securities of the issuing corporation.

D. Valuation

1. The "as of the end of the last business day" rule

The proposed regulations require that, if the signing date rule applies, the consideration to be tendered in respect of the target corporation shares surrendered be valued as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization. One comment requested clarification of the meaning of *as of the end of the last business day*. That comment suggested that an average of the high and low trade price on that day should be an acceptable value for this purpose. Alternatively, the comment suggested that if a single trade were to determine the value of the issuing corporation stock, the closing price of the issuing corporation stock on the relevant market should be used. The comment further described an approach for identifying the relevant stock market.

In response to these comments, these final regulations remove the requirement that the consideration be valued as of the end of the last business day before the first date that there is a binding contract. Instead, they provide general guidance that the consideration to be exchanged for target corporation shares pursuant to a contract must be valued the day before such contract is a binding contract.

2. New issuances

The IRS and Treasury Department recognize that the application of the requirement that the consideration to be exchanged for proprietary interests in the target corporation be valued on the last business day before the first date there is a binding contract to effect the potential reorganization may be unclear in cases in which the consideration does not exist prior to the effective date of the reorganization. For example, suppose that, in the potential reorganization, the issuing corporation will issue a new class of its stock in exchange for the shares of the target corporation. The question has arisen as

to how to value those to be issued shares under the signing date rule, given that they do not exist on the last business day before the first date that there is a binding contract to effect the potential reorganization. Thus, these final regulations clarify that this new class of stock will be deemed to have been issued on the last business day before the first date there is a binding contract to effect the potential reorganization for purposes of applying the signing date rule.

E. Escrowed Stock

1. Pre-closing covenants

The proposed regulations provide that placing part of the stock issued or money paid into escrow to secure customary target representations and warranties will not prevent the consideration in a contract from being fixed. One comment suggested that this rule should be expanded to include consideration placed in escrow to secure target's performance of customary pre-closing covenants (rather than representations and warranties). That commentator stated that there is no reason to distinguish between customary pre-closing covenants, on the one hand, and customary representations and warranties, on the other hand. The IRS and Treasury Department agree. Accordingly, these final regulations extend the rule related to escrows to include consideration placed in escrow to secure target's performance of customary pre-closing covenants.

2. Effect of escrowed consideration on satisfaction of COI

Some commentators have indicated that certain examples in the proposed regulations suggest that escrowed stock, even if it is forfeited to the issuing corporation, is treated as preserving the target shareholders' proprietary interests in the target corporation. The IRS and Treasury Department believe that escrowed consideration that is forfeited should not be taken into account in determining whether the COI requirement is satisfied. This conclusion reflects the view that the forfeiture of escrowed consideration is in substance a purchase price adjustment. Accordingly, the examples in these final regulations reflect that forfeited stock is not

treated as preserving the target corporation shareholders' proprietary interests in the target corporation and forfeited non-stock consideration is not treated as counting against the preservation of the target corporation's shareholders' proprietary interest in the target corporation. The IRS and Treasury Department continue to consider the effect on COI of escrowed consideration and contingent consideration.

3. Revenue Procedure 84-42

One commentator requested clarification regarding the impact of the proposed regulations on Revenue Procedure 84-42, 1984-1 C.B. 521. Rev. Proc. 84-42 includes certain operating rules of the IRS regarding the issuance of letter rulings, including the circumstances in which the placing of stock in escrow will not prevent the IRS from issuing a private letter ruling. The IRS and Treasury Department continue to review the existing revenue procedures relating to reorganizations in light of the numerous regulatory changes since the publication of these procedures and the policy against issuing rulings in the reorganization area unless there is a significant issue, which is reflected in Rev. Proc. 2005-3. Rev. Proc. 84-42 is not amended at this time.

F. Anti-Dilution Provisions

One comment suggested that consideration in a contract should not be treated as fixed unless the contract includes a customary anti-dilution provision. The commentator posited an example in which the absence of an anti-dilution clause and the occurrence of a stock split with respect to the stock of the issuing corporation prior to the effective date of a potential reorganization results in the value of the consideration received in respect of the target corporation shares being substantially different from its value on the day before the first date there is a binding contract.

The IRS and Treasury Department do not believe that the absence of a customary anti-dilution provision should necessarily preclude the application of the signing date rule as dilution may not, in fact, occur. However, the IRS and Treasury Department are concerned that application of the signing date rule is not appropriate if the contract does not contain an anti-dilution clause relating to the stock of the issu-

ing corporation and the issuing corporation alters its capital structure between the first date there is an otherwise binding contract to effect the potential reorganization and the effective date of the potential reorganization in a manner that materially alters the economic arrangement of the parties to the binding contract. Accordingly, these final regulations provide that, in such cases, the consideration will not be treated as fixed.

G. Contract modifications

The proposed regulations require that if a term of a binding contract that relates to the amount or type of consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, then the date of the modification shall be treated as the first date there is a binding contract. Thus, such a modification requires that the stock of the issuing corporation be valued as of the end of the last business day before the date of the modification in order to determine whether the transaction satisfies the COI requirement.

One commentator suggested that a contract should not be treated as being modified for this purpose if the modification has the sole effect of increasing the number of shares of the issuing corporation to be received by the target shareholders. The IRS and Treasury Department agree that, because such a modification only enhances the preservation of the target corporation's shareholders' proprietary interests, it is not appropriate to value the consideration to be provided to the target corporation shareholders as of the day before the date of the modification rather than as of the day before the date of the original contract, at least in cases in which the transaction would have satisfied the COI requirement under the signing date rule if there had been no modification. Therefore, these final regulations provide that a modification that has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders will not be treated as a modification if the execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interest in the target

corporation if there had been no modification. In such cases, the determination of whether a proprietary interest in the target corporation has been preserved is made by reference to the value of the consideration as of the last business day before the first date the contract was binding, not the last business day before the modification. The IRS and Treasury Department continue to consider whether this exception should be extended to certain cases in which the modification results in not only additional shares of the issuing corporation to be issued to target corporation shareholders, but also additional money or other property to be transferred to target corporation shareholders.

H. Application of Principle Illustrated by Examples

One commentator asked whether the principle that the COI requirement is satisfied where 40 percent of the target corporation stock is exchanged for stock in the issuing corporation that is illustrated in the examples of the proposed regulations (which relate to the application of the signing date rule) also applies in cases in which the signing date rule does not apply. The IRS and Treasury Department believe that this principle is equally applicable to cases in which the signing date rule does not apply as it is to cases in which the signing date rule does apply.

I. Restricted Stock

The IRS and Treasury Department are continuing to consider the appropriate treatment of restricted stock in the determination of whether the COI requirement is satisfied.

Special Analyses

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

Drafting Information

The principal author of these regulations is Christopher M. Bass of the Office of the Associate Chief Counsel (Corporate). 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 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.368-1 is amended as follows:

1. Paragraph (e)(1)(i) is amended as follows:

A. Removing the language “(e)(3)” and adding in its place “(e)(4)” wherever it appears.

B. Removing the language “(e)(3)(i)(A)” and adding “(e)(4)(i)(A)” in its place.

2. Redesignating paragraphs (e)(2) through (e)(7) as (e)(3) through (e)(8), respectively.

3. Adding a new paragraph (e)(2).

4. In newly designated paragraphs (e)(3) through (e)(8), removing the language “(e)(6)” wherever it appears, and adding the language “(e)(7)” in its place.

5. In newly designated paragraphs (e)(3) through (e)(8), removing the language “(e)(4)” wherever it appears, and adding the language “(e)(5)” in its place.

6. In newly designated paragraphs (e)(3) through (e)(8), removing the language “(e)(3)” wherever it appears, and adding the language “(e)(4)” in its place.

7. In newly designated paragraphs (e)(3) through (e)(8), removing the language “(e)(2)” wherever it appears, and adding the language “(e)(3)” in its place.

8. In newly designated paragraph (e)(4)(ii)(B), removing the language “(e)(3)(i)(A)” wherever it appears, and adding the language “(e)(4)(i)(A)” in its place.

9. In newly designated paragraph (e)(7), *Example 1*, removing the language “(e)(1) and (2)” wherever it appears, and adding the language “(e)(1) and (3)” in its place.

10. In newly designated paragraph (e)(7), *Example 2*, make the following revisions:

A. Remove the language “(e)(3)(i)(B)” wherever it appears, and add the language “(e)(4)(i)(B)” in its place.

B. Remove the language “(e)(3)(i)(A) and (ii)(B)” wherever it appears, and add the language “(e)(4)(i)(A) and (ii)(B)” in its place.

11. In newly designated paragraph (e)(7), *Example 3*, removing the language “(e)(1) and (2)” wherever it appears, and adding the language “(e)(1) and (3)” in its place.

12. In newly designated paragraph (e)(7), *Example 4*, paragraph (iii), removing the language “(e)(3)(i)(A) and (B)” wherever it appears, and adding the language “(e)(4)(i)(A) and (B)” in its place.

13. In newly designated paragraph (e)(7), *Example 6*, removing the language “(e)(3)(i)(A) and (B)” wherever it appears, and adding the language “(e)(4)(i)(A) and (B)” in its place.

14. In newly designated paragraph (e)(7), *Example 8*, removing the language “(e)(3)(i)(A)” wherever it appears, and adding the language “(e)(4)(i)(A)” in its place.

15. Revising newly designated paragraph (e)(8).

The addition and revision read as follows:

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

* * * * *

(e) * * *

(2) *Measuring continuity of interest—(i) In general.* In determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for the proprietary interests in the target corporation pursuant to a contract to effect the potential reorganization shall be valued on the last business

day before the first date such contract is a binding contract, if such contract provides for fixed consideration.

(ii) *Binding contract*—(A) *In general*. A binding contract is an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) shall not prevent an instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, shall not prevent an instrument from being a binding contract.

(B) *Modifications*—(1) *In general*. If a term of a binding contract that relates to the amount or type of the consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, the date of the modification shall be treated as the first date there is a binding contract.

(2) *Exception*. Notwithstanding paragraph (e)(2)(ii)(B)(1) of this section, a modification of a term that relates to the amount or type of consideration the target shareholders will receive in a potential reorganization will not be treated as a modification for purposes of that provision if—

(i) That modification has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders; and

(ii) The execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interest in the target corporation if there had been no modification.

(C) *Tender offers*. For purposes of this paragraph (e)(2), a tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934 [15 U.S.C. 78n(d)(1)] and Regulation 14D (17 CFR 240.14d-1 through 240.14d-101) and is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees. If a modification (not pursuant to a binding contract) of such a tender offer is subject to the provisions of Reg-

ulation 14d-6(c) (17 CFR 240.14d-6(c)) and relates to the amount or type of the consideration received in the tender offer, then the date of the modification shall be treated as the first date there is a binding contract.

(iii) *Fixed consideration*—(A) *In general*. A contract provides for fixed consideration if it provides—

(1) The number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for all of the proprietary interests in the target corporation;

(2) The number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for each proprietary interest in the target corporation;

(3) The percentage of the number of shares of each class of proprietary interests in the target corporation, or the percentage (by value) of the proprietary interests in the target corporation, to be exchanged for stock of the issuing corporation, provided that the proprietary interests in the target corporation to be exchanged for stock of the issuing corporation and the proprietary interests in the target corporation to be exchanged for consideration other than stock of the issuing corporation each represents an economically reasonable exchange as of the last business day before the first date there is a binding contract to effect the potential reorganization; or

(4) The percentage of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation, provided that the portion of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation and the portion of each proprietary interest in the target corporation to be exchanged for consideration other than stock of the issuing corporation each represents an economically reasonable exchange as of the last business day before the first date there is a binding contract to effect the potential reorganization.

(B) *Shareholder elections*—(1) *In general*. A contract that is not described in paragraph (e)(2)(iii)(A) of this section and pursuant to which a target corporation shareholder has an election to receive

stock and/or money and other property in respect of target corporation stock is treated as providing for fixed consideration if the contract provides—

(i) The minimum number of shares of each class of stock of the issuing corporation and the maximum amount of money and other property (identified either by value or by specific description) to be exchanged for all of the proprietary interests in the target corporation; or

(ii) The minimum percentage of the number of shares of each class of proprietary interests in the target corporation, or the minimum percentage (by value) of the proprietary interests in the target corporation, to be exchanged for stock of the issuing corporation, provided that the proprietary interests in the target corporation to be exchanged for stock of the issuing corporation and the proprietary interests in the target corporation to be exchanged for consideration other than stock of the issuing corporation each represents an economically reasonable exchange as of the last business day before the first date there is a binding contract to effect the potential reorganization.

(2) *Special rules*. (i) In the case of a shareholder election described in paragraph (e)(2)(iii)(B)(1)(i) of this section, the determination of whether a proprietary interest in the target corporation is preserved shall be made by assuming the issuance by the issuing corporation of the minimum number of shares of each class of stock of the issuing corporation and the maximum amount of money and other property allowable under the contract and without regard to the number of shares of each class of stock of the issuing corporation and the amount of money and other property actually exchanged thereafter for proprietary interests in the target corporation.

(ii) In the case of a shareholder election described in paragraph (e)(2)(iii)(B)(1)(ii) of this section, the determination of whether a proprietary interest in the target corporation is preserved shall be made by assuming the issuance of issuing corporation stock in exchange for the minimum percentage of the number of shares of each class of proprietary interests in the target corporation, or the minimum percentage (by value) of proprietary interests in the target corporation, as the case may be, to be exchanged for stock of the issuing

corporation allowable under the contract and without regard to the percentage of the number of shares of each class of proprietary interests in the target corporation, or the percentage (by value) of proprietary interests in the target corporation, actually exchanged for stock of the issuing corporation.

(C) *Contingent consideration*—(I) *In general*. In general, the fact that a contract provides for contingent consideration will prevent a contract from being treated as providing for fixed consideration. However, a contract will not fail to be treated as providing for fixed consideration solely as a result of a provision that provides for contingent consideration, if—

(i) The contingent consideration consists solely of stock of the issuing corporation; and

(ii) The execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if none of the contingent consideration were delivered to the target corporation shareholders.

(2) *Exception for escrows*. For purposes of paragraph (e)(2)(iii)(C)(I) of this section, contingent consideration does not include consideration paid in escrow to secure target's performance of customary pre-closing covenants or customary target representations and warranties.

(D) *Escrows*. Placing part of the consideration to be exchanged for proprietary interests in the target corporation in escrow to secure target's performance of customary pre-closing covenants or customary target representations and warranties will not prevent a contract from being treated as providing for fixed consideration.

(E) *Anti-dilution clauses*. The presence of a customary anti-dilution clause will not prevent a contract from being treated as providing for fixed consideration. However, the absence of such a clause will prevent a contract from being treated as providing for fixed consideration if the issuing corporation alters its capital structure between the first date there is an otherwise binding contract to effect the potential reorganization and the effective date of the potential reorganization in a manner that materially alters the economic arrangement of the parties to the binding contract.

(F) *Dissenters' rights*. The possibility that some shareholders may exercise dissenters' rights and receive consideration other than that provided for in the binding contract will not prevent the contract from being treated as providing for fixed consideration.

(G) *Fractional shares*. The fact that money may be paid in lieu of issuing fractional shares will not prevent a contract from being treated as providing for fixed consideration.

(iv) *Valuation of new issuances*. For purposes of applying paragraph (e)(2)(i) of this section, any class of stock, securities, or indebtedness that the issuing corporation issues to the target corporation shareholders pursuant to the potential reorganization and that does not exist before the first date there is a binding contract to effect the potential reorganization is deemed to have been issued on the last business day before the first date there is a binding contract to effect the potential reorganization.

(v) *Examples*. For purposes of the examples in this paragraph (e)(2)(v), P is the issuing corporation, T is the target corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A is an individual, no transactions other than those described occur, and the transactions are not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e)(2):

Example 1. Application of signing date rule. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and \$60 of cash in exchange for all of the outstanding stock of T. Twenty of the P shares, however, will be placed in escrow to secure customary target representations and warranties. The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is \$1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is \$.25 per share. None of the stock placed in escrow is returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$40 of P stock and \$60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 2. Treatment of forfeited escrowed stock.

(i) The facts are the same as in *Example 1* except that T's breach of a representation results in the escrowed consideration being returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$20 of P stock and \$60 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

(ii) The facts are the same as in *Example 2* (i) except that the consideration placed in escrow consists solely of eight of the P shares and \$12 of the cash. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$32 of P stock and \$48 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 3. Redemption of stock received pursuant to binding contract. The facts are the same as in *Example 1* except that A owns 50 percent of the outstanding stock of T immediately prior to the merger and receives 10 P shares and \$30 in the merger and an additional 10 P shares upon the release of the stock placed in escrow. In connection with the merger, A and S agree that, immediately after the merger, S will purchase any P shares that A acquires in the merger for \$1 per share. Shortly after the merger, S purchases A's P shares for \$20. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. In addition, S is a person related to P under paragraph (e)(4)(i)(A) of this section. Accordingly, A is treated as exchanging his T shares for \$50. Because, for continuity of interest purposes, the T stock is exchanged for \$20 of P stock and \$80 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 4. Modification of binding contract—continuity not preserved. The facts are the same as in *Example 1* except that on April 1 of Year 1, the parties modify their contract. Pursuant to the modified contract, which is a binding contract, the T shareholders will receive 50 P shares (an additional 10 shares) and \$75 of cash (an additional \$15 of cash)

in exchange for all of the outstanding T stock. On March 31 of Year 1, the value of the P stock is \$.50 per share. Under paragraph (e)(2) of this section, although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. Because the modified contract provides for the number of P shares and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, the modified contract is a binding contract providing for fixed consideration as of April 1 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on March 31 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$25 of P stock and \$75 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 5. Modification of binding contract disregarded—continuity preserved. The facts are the same as in *Example 4* except that, pursuant to the modified contract, which is a binding contract, the T shareholders will receive 60 P shares (an additional 20 shares as compared to the original contract) and \$60 of cash in exchange for all of the outstanding T stock. In addition, on March 31 of Year 1, the value of the P stock is \$.40 per share. Under paragraph (e)(2) of this section, although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. Nonetheless, the modification has the sole effect of providing for the issuance of additional P shares to the T shareholders. In addition, the execution of the terms of the contract without regard to the modification would have resulted in the preservation of a substantial part of the value of the T shareholders' proprietary interest in T because, for continuity of interest purposes, the T stock would have been exchanged for \$40 of P stock and \$60 of cash. Therefore, the modification is not treated as a modification under paragraph (e)(2) of this section. Accordingly, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Despite the modification, the transaction continues to satisfy the continuity of interest requirement.

Example 6. New issuance. The facts are the same as in *Example 1*, except that, in lieu of the \$60 of cash, the T shareholders will receive a new class of P securities that will be publicly traded. In the aggregate, the securities will have a stated principal amount of \$60 and bear interest at the average LIBOR (London Interbank Offered Rates) during the 10 days prior to the potential reorganization. If the T shareholders had been issued the P securities on January 2 of Year 1, the P securities would have had a value of \$60 (determined by reference to the value of comparable publicly traded securities). Whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock and the P securities to be issued to the T shareholders on January 2 of Year 1. Under paragraph (e)(2)(iv) of this

section, for purposes of valuing the new P securities, they will be treated as having been issued on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$40 of P stock and \$60 of other property, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 7. Economically unreasonable exchange. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 2 of Year 1. At that time, A is T's sole shareholder. Pursuant to the contract, 60 percent of the T stock will be exchanged for \$80 of cash and 40 percent of the T stock will be exchanged for 20 shares of P stock. As of January 2, 20 shares of P stock have a value of \$20, representing only 20 percent of the value of the total consideration to be received by the T shareholders. Because the percentage of proprietary interests in the target corporation to be exchanged for stock of the issuing corporation and the proprietary interests in the target corporation to be exchanged for money do not each represent an economically reasonable exchange as of the last business day before the first date there is a binding contract to effect the potential reorganization, under paragraph (e)(2)(iii)(A)(3) of this section, the contract is not treated as a binding contract that provides for fixed consideration.

Example 8. Absence of anti-dilution clause. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and \$60 of cash in exchange for all of the outstanding stock of T. The contract does not contain a customary anti-dilution provision. The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is \$1 per share. On April 10 of Year 1, P issues its stock to effect a stock split; each shareholder of P receives an additional share of P for each P share that it holds. On April 11 of Year 1, the value of the P stock is \$.50 per share. Because P altered its capital structure between January 3 and June 1 of Year 1 in a manner that materially alters the economic arrangement of the parties, under paragraph (e)(2)(iii)(E) of this section, the contract is not treated as a binding contract that provides for fixed consideration.

Example 9. Shareholder election with a proration mechanism. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, at the shareholders' election, each share of T will be exchanged for cash of \$1 or, alternatively, P stock that has a value of \$1, if the value of each share of P stock is at least \$.80 and no more than \$1.20 on the effective date of the potential reorganization; 1.25 shares of P stock, if the value of each share of P stock is less than \$.80 on the effective date of the potential reorganization; or .83 shares of P stock, if the value of each share of P stock is more than \$1.20 on the effective date of the potential reorganization. In addition, the contract provides for a proration mechanism to ensure that 50 percent of the T shares will be exchanged for cash and 50 percent of the T shares will be exchanged for P stock. On January 2 of Year 1, T has 100 shares outstanding. The P stock is listed on an established market. On January 2 of Year 1,

the value of the P stock is \$1 per share. Because the contract provides for the percentage of the number of shares of each class of proprietary interests in T, and the percentage (by value) of the proprietary interests in T, to be exchanged for stock of P and the other requirements of paragraph (e)(2)(iii)(A)(3) of this section are satisfied, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$50 of P stock and \$50 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

* * * * *

(8) *Effective date.* Paragraphs (e)(1) and (e)(3) through (e)(7) of this section apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. Paragraph (e)(1)(ii) of this section, however, applies to transactions occurring after August 30, 2000, unless the transaction occurs pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter. Taxpayers who entered into a binding agreement on or after January 28, 1998, and before August 30, 2000, may request a private letter ruling permitting them to apply the final regulation to their transaction. A private letter ruling will not be issued unless the taxpayer establishes to the satisfaction of the IRS that there is not a significant risk of different parties to the transaction taking inconsistent positions, for Federal tax purposes, with respect to the applicability of the final regulations to the transaction. Paragraph (e)(2) of this section applies to transactions occurring pursuant to binding contracts entered into after September 16, 2005.

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

Approved September 6, 2005.

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

(Filed by the Office of the Federal Register on September 15, 2005, 8:45 a.m., and published in the issue of the Federal Register for September 16, 2005, 70 F.R. 54631)

Part III. Administrative, Procedural, and Miscellaneous

Katrina Relief Summary Notice

Notice 2005-73

PURPOSE

This notice summarizes and clarifies the relief previously granted by the Internal Revenue Service (IRS) under sections 6081, 6161, 6656, and 7508A of the Internal Revenue Code with respect to taxpayers affected by Hurricane Katrina. The IRS is endeavoring to identify affected taxpayers who are eligible for relief. In order to assist the IRS in identifying affected taxpayers to ensure that they receive the relief to which they are entitled, affected taxpayers should mark "Hurricane Katrina" in red ink on the top of their returns and other documents for which the IRS has postponed the due dates. Affected taxpayers should also identify themselves as an affected taxpayer if the IRS sends them a notice or makes any other direct contact, e.g., telephone calls.

In response to Hurricane Katrina, on August 28, 2005 and August 29, 2005, the President issued four federal disaster declarations covering the states of Alabama, Mississippi, Louisiana, and Florida. The presidential declarations authorized, under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. §§ 5121-5206 (Stafford Act), the Federal Emergency Management Agency (FEMA) to provide Individual Assistance, Public Assistance, and assistance under the Hazard Mitigation Grant Program to counties and parishes in each state. Under that authority, FEMA determined that certain counties and parishes within those states were eligible for Individual Assistance, Public Assistance, or both. FEMA also determined that all counties and parishes in all four of the states were eligible to apply for assistance under the Hazard Mitigation Grant Program.

By news releases issued on August 30, 2005, September 2, 2005, September 8, 2005, and September 14, 2005, the IRS granted relief from filing and payment deadlines, and granted relief from the acts listed in Treas. Reg. § 301.7508A-1(c)(1) and Rev. Proc. 2005-27, 2005-20 I.R.B. 1050, for taxpayers in the counties and

parishes designated by FEMA for Individual Assistance and/or Public Assistance. See IR-2005-84, IR-2005-91, IR-2005-96, and IR-2005-103. The counties and parishes designated by FEMA as being eligible for Individual Assistance and/or Public Assistance constitute a "covered disaster area" within the meaning of section 301.7508A-1(d)(2). See the Appendix to this notice for a list of counties and parishes designated by FEMA for Individual Assistance and Public Assistance (counties and parishes designated by FEMA for Individual Assistance are generally also granted Public Assistance, but for purposes of this notice will be referred to as Individual Assistance areas). The IRS will continue to monitor closely the impact of Hurricane Katrina and may grant other relief under appropriate circumstances for affected taxpayers or affected areas.

The relief detailed below applies to all the counties and parishes listed in the Appendix to this notice, and to counties and parishes that FEMA later designates as being eligible for Individual and/or Public Assistance as a result of the devastation caused by Hurricane Katrina.

BACKGROUND

Under the Stafford Act, the President can authorize FEMA to implement several different types of assistance in response to a disaster. Pursuant to this authority, and based on the severity of the disaster, FEMA designates certain areas affected by the disaster as eligible for Individual Assistance and/or Public Assistance.

When the President declares a disaster and FEMA designates areas for assistance, the IRS has authority under section 7508A to grant blanket relief to taxpayers. In addition, the IRS can grant blanket relief under sections 6081, 6161, and any other provision providing for a waiver of a penalty for reasonable cause, such as section 6656.

Ordinarily, the IRS only grants blanket relief for taxpayers associated with the areas FEMA designates for Individual Assistance because in those areas the devastation from the disaster is more widespread. However, in view of the extreme need for relief in the aftermath of Hurricane Katrina, the IRS granted relief for tax-

payers associated with those areas designated by FEMA for Individual Assistance and Public Assistance.

Relief with respect to a Presidentially-declared disaster under sections 6081, 6161, 6656, and 7508A is only available when the IRS grants such relief. Generally, the IRS will publish a notice or issue other guidance (including an IRS News Release) authorizing the relief. Such guidance will describe the relief, the duration of the relief, and the location of the covered disaster area.

Summary of the Acts for Which a Period May be Disregarded

Section 6081 provides that the Secretary may grant a reasonable extension of time (generally not to exceed 6 months) for filing any return, declaration, statement, or other document required by the Internal Revenue Code or by regulations thereunder.

Section 6161 provides that the Secretary may grant a reasonable extension of time (generally not to exceed 6 months) for paying the amount (or any installments) of tax shown or required to be shown on any return or declaration required by the Code or by regulations thereunder.

Section 6656 provides for an addition to tax for any failure to deposit tax in a government depository as required by the Code or regulations on the date prescribed therefor, unless such failure is due to reasonable cause and not due to willful neglect.

Section 7508A provides the Secretary with authority to postpone the time for performing certain acts under the internal revenue laws for a taxpayer the Secretary determines is affected by a Presidentially-declared disaster. Section 7508A(a)(2) also provides the Secretary with authority to disregard a period of up to one year in determining the amount of any interest, penalty, additional amount, or addition to the tax for an affected taxpayer. Pursuant to section 7508A(a) and section 301.7508A-1, a period of up to one year may be disregarded in determining whether the performance of certain acts is timely under the internal revenue laws. Section 301.7508A-1(c)(1) lists several acts performed by taxpayers for

which section 7508A relief may apply. Among these acts are the filing of certain tax returns; the payment of certain taxes; the making of deductible contributions to certain retirement plans and individual retirement arrangements; the filing of a Tax Court petition; the filing of a claim for credit or refund of tax; and the bringing of a lawsuit upon a claim for credit or refund of tax.

Revenue Procedure 2005-27 provides a list of time-sensitive acts, the performance of which may be postponed under section 7508A. The list of acts in Rev. Proc. 2005-27 supplements the list of postponed acts in section 301.7508A-1 of the regulations. The acts set forth in Rev. Proc. 2005-27 are those that the IRS commonly postpones in the event of a Presidentially-declared disaster.

Affected Taxpayers Whose Acts May be Postponed

Section 301.7508A-1(d)(1) describes several types of "affected taxpayers" eligible for postponement of up to one year. These taxpayers include any individual whose principal residence, and any business entity whose principal place of business, is located in the covered disaster area; any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in the covered disaster area; any individual whose principal residence, and any business entity whose principal place of business, is not located in the covered disaster area, but whose records necessary to meet a filing or payment deadline are maintained in the covered disaster area; any estate or trust that has tax records necessary to meet a filing or payment deadline in a covered disaster area; and any spouse of an affected taxpayer, solely with regard to a joint return of the husband and wife. Therefore, taxpayers located outside of the covered disaster area may qualify for relief.

Additionally, under section 301.7508A-1(d)(1)(vii), the IRS may determine that any other person is affected by a Presidentially-declared disaster and therefore eligible for relief. Accordingly, the IRS has determined that the following persons are also affected by Hurricane Katrina and its aftermath: (1) all workers assisting in the relief activities in the

covered disaster areas, regardless of whether they are affiliated with recognized government or philanthropic organizations; (2) any individual whose principal residence, and any business entity whose principal place of business, is not located in the covered disaster area, but whose tax professional/practitioner is located in the covered disaster area; and (3) individuals, visiting the covered disaster areas, who were killed or injured as a result of Hurricane Katrina and its aftermath. For purposes of (3) above, the estate of an individual visiting the covered disaster who was killed as a result of the hurricane is also considered to be an affected taxpayer.

SUMMARY OF RELIEF GRANTED WITH RESPECT TO HURRICANE KATRINA

The news releases issued by the IRS on August 30, 2005, September 2, 2005, September 8, 2005, and September 14, 2005, granted the following relief:

(1) Affected taxpayers as defined by section 301.7508A-1(d)(1) and clarified by this notice have until January 3, 2006, to file certain federal tax returns otherwise due (originally or on extension) on or after August 29, 2005 (August 24, 2005, for Florida affected taxpayers), and on or before January 3, 2006, and to pay the tax shown or required to be shown on those returns. In addition, the period from August 29, 2005 (August 24, 2005 for Florida affected taxpayers), until January 3, 2006, will be disregarded in the calculation of any interest and any failure to file or pay addition to tax under section 6651. Thus, any interest or addition to tax for failure to file a return or to pay the tax due accruing as of August 29, 2005 (August 24, 2005 for Florida affected taxpayers), would stop accruing as of that date and would start accruing again after January 3, 2006 (or such later date that the IRS might subsequently provide), if the return was not filed or tax was not paid by that date. An affected taxpayer who receives an IRS notice asserting a penalty for this period should call the number on the notice or the IRS toll-free disaster hotline at 1-866-562-5227 to receive penalty abatement. The applicable returns include individual income tax returns (Forms 1040, 1040A, 1040EZ, 1040NR, or 1040NR-EZ), gift tax returns

(Forms 709 and 709-A), partnership returns (Form 1065), corporate income tax returns (Forms 1120 and 1120S), estate and trust income tax returns (Form 1041), estate tax returns (Form 706), annual returns filed by tax-exempt organizations (Form 990 (series)), certain excise tax returns (Form 720) and employment tax returns (Form 941). See Treas. Reg. § 301.7508A-1(c)(1)(i) for a list of affected returns.

(2) Although a postponement is provided for filing certain excise tax and employment tax returns, and making payments of excise tax and employment tax, most employers and entities responsible for excise and employment tax must, under section 6302 and the regulations thereunder, deposit the tax throughout the return period (usually every quarter). Although the time for making these deposits has not been extended under section 7508A, the IRS has authority under sections 6656 and 7508A(a)(2) to waive the penalty that would otherwise apply to a failure to make a timely deposit. The IRS has concluded that taxpayers affected by Hurricane Katrina may have difficulty in making timely federal tax deposits in accordance with section 6302. Accordingly, for deposits required to be made by affected taxpayers on or after August 29, 2005 (August 24, 2005 for Florida affected taxpayers), and on or before January 3, 2006, the IRS will waive the addition to tax under section 6656 for the failure to timely make any deposit of tax if the deposit is made on or before January 3, 2006.

The relief from the failure to timely deposit addition to tax is intended for taxpayers who are unable to meet their deposit obligations because their (or their service provider's) records, computers, or other essential supporting services were damaged, or essential personnel were injured, by the hurricane or any subsequent flooding. Thus, although the waiver applies to all affected taxpayers, taxpayers that are reasonably able to make their deposits are encouraged to do so.

(3) The due date of any estimated tax payment for tax year 2005 originally due on or after August 29, 2005 (August 24, 2005 for Florida affected taxpayers), and before January 3, 2006, for taxpayers located in the covered disaster area, and other affected taxpayers, is postponed

until January 3, 2006. This applies to estimated tax payments made by individuals, corporations, estates, and trusts. Thus, for individuals and calendar year corporations, the third estimated tax payment for tax year 2005, due on September 15, 2005, is not due until January 3, 2006. Affected taxpayers will not be subject to penalties for failure to pay estimated tax installments for tax year 2005 with respect to installments that were originally due on or after August 29, 2005 (August 24, 2005 for Florida affected taxpayers), and before January 3, 2006, as long as such installments are paid by January 3, 2006.

(4) A postponement until January 3, 2006, is granted for each act listed in section 301.7508A-1(c)(1) and Rev. Proc. 2005-27 for affected taxpayers, excluding Florida affected taxpayers, if the last day to perform the act would otherwise fall within the period beginning on August 29, 2005, and ending on January 3, 2006. For Florida affected taxpayers, the period begins on August 24, 2005, and ends on January 3, 2006.

(5) Partners, S corporation shareholders, and beneficiaries of trusts and estates use the information reported to them on Schedule K-1 by their partnerships, corporations, trusts, or estates to prepare their own income tax returns. If the income tax return of the partnership, S corporation, trust or estate was postponed or extended, the partner, S corporation shareholder, or beneficiary of a trust or estate might not receive the Schedule K-1 prior to the due date or extended due date of the partner's, shareholder's, or beneficiary's income tax return. The income tax return of a partner, shareholder, or beneficiary is *not* postponed or extended solely because the entity (the partnership, S corporation, trust, or estate) is an affected taxpayer.

Partners, shareholders, and beneficiaries of trusts and estates may request extensions of time to file their income tax returns. See I.R.C. § 6081. If the Schedule K-1 is not received by the extended due date, the partner, shareholder, or beneficiary should prepare and file the income tax return on a timely basis by making a reasonable estimate in good faith of items of income, gain, loss, deduction, and credit attributable to the taxpayer's interest in the entity. Later, when the Schedule K-1 is received, the taxpayer should prepare an amended return reflecting the

items reported on the Schedule K-1. If the taxpayer's original return underestimated items of income or gain, or overstated items of deduction, loss, or credit, and a late payment penalty attributable to these items is assessed, the taxpayer should request an abatement of the penalty for reasonable cause. If the original return was prepared in good faith based on reasonable estimates of the tax items attributable to the entity, the IRS will waive or abate penalties for late payment.

(6) Taxpayers who believe they are entitled to relief under the news releases issued on August 30, 2005, September 2, 2005, September 8, 2005, and September 14, 2005, as clarified by this notice, should mark "Hurricane Katrina" in red ink on the top of their return and other documents submitted to the IRS. In the counties and parishes designated for Individual Assistance, relief will automatically be granted, but affected taxpayers are nonetheless strongly encouraged to mark their returns and other documents or otherwise alert the IRS to the need for relief. In the counties and parishes designated for Public Assistance, and for other affected taxpayers, relief will be granted if the IRS is notified of the need for relief. Accordingly, these taxpayers need to mark their returns and documents, or otherwise alert the IRS to the need for relief.

DRAFTING INFORMATION

The principal author of this notice is Dillon Taylor of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice, contact Dillon Taylor at (202) 622-4940 (not a toll-free call).

APPENDIX

The August 28, 2005 declaration for Florida, as amended on September 6, 2005, covers the following 11 counties designated for Public Assistance: Bay, Broward, Collier, Escambia, Franklin, Gulf, Miami-Dade, Monroe, Okaloosa, Santa Rosa, and Walton.

The August 29, 2005 declaration for Alabama, as amended on September 9, and 11, 2005, covers the following 10 counties designated Individual Assistance: Baldwin, Choctaw, Clarke, Greene, Hale,

Mobile, Pickens, Sumter, Tuscaloosa, and Washington; and the following 12 counties eligible for Public Assistance: Bibb, Colbert, Cullman, Jefferson, Lamar, Lauderdale, Marengo, Marion, Monroe, Perry, Wilcox, and Winston.

The August 29, 2005 declaration for Mississippi, as amended on September 4, 6, and 11, 2005, covers the following 47 counties designated for Individual Assistance: Adams, Amite, Attala, Claiborne, Choctaw, Clarke, Copiah, Covington, Franklin, Forrest, George, Greene, Hancock, Harrison, Hinds, Jackson, Jasper, Jefferson, Jefferson Davis, Jones, Kemper, Lamar, Lauderdale, Lawrence, Leake, Lincoln, Lowndes, Madison, Marion, Neshoba, Newton, Noxubee, Oktibbeha, Pearl River, Perry, Pike, Rankin, Scott, Simpson, Smith, Stone, Walthall, Warren, Wayne, Wilkinson, Winston, and Yazoo; and the following 35 counties designated for Public Assistance: Alcorn, Benton, Bolivar, Calhoun, Carroll, Chickasaw, Clay, Coahoma, DeSoto, Grenada, Holmes, Humphreys, Issaquena, Itawamba, Lafayette, Leflore, Lee, Marshall, Monroe, Montgomery, Panola, Pontotoc, Prentiss, Quitman, Sharkey, Sunflower, Tallahatchie, Tate, Tippah, Tishomingo, Tunica, Union, Washington, Webster, and Yalobusha.

The August 29, 2005 declaration for Louisiana, as amended on September 9, 2005, covers the following 31 parishes designated for Individual Assistance: Acadia, Ascension, Assumption, Calcasieu, Cameron, East Baton Rouge, East Feliciana, Iberia, Iberville, Jefferson, Jefferson Davis, Lafayette, Lafourche, Livingston, Orleans, Pointe Coupee, Plaquemines, St. Bernard, St. Charles, St. Helena, St. James, St. John, St. Mary, St. Martin, St. Tammany, Tangipahoa, Terrebonne, Vermilion, Washington, West Baton Rouge, and West Feliciana; and the following 33 parishes designated for Public Assistance: Allen, Avoyelles, Beauregard, Bienville, Bossier, Caddo, Caldwell, Catahoula, Claiborne, Concordia, Desoto, East Carroll, Evangeline, Franklin, Grant, Jackson, LaSalle, Lincoln, Madison, Morehouse, Natchitoches, Ouachita, Rapides, Red River, Richland, Sabine, St. Landry, Tensas, Union, Vernon, Webster, West Carroll, and Winn.

Announcement of Rules to be Included in Regulations Under Section 367(a) Regarding the Effect of Certain Exchanges on Gain Recognition Agreements and Request for Comments

Notice 2005-74

SECTION 1. OVERVIEW

This notice announces that Treasury and the Internal Revenue Service (IRS) will amend the regulations under section 367(a) of the Internal Revenue Code regarding the application of Treas. Reg. § 1.367(a)-8, including the provisions addressing the treatment of gain recognition agreements as a result of certain common asset reorganizations involving the U.S. transferor, the transferee foreign corporation, and the transferred corporation. These regulations will supplement the existing rules under Treas. Reg. § 1.367(a)-8, including the rules under Treas. Reg. § 1.367(a)-8(f) through (h). As described below, taxpayers may rely on this notice for exchanges occurring on or after July 20, 1998 (the effective date of Treas. Reg. § 1.367(a)-8).

No inference is intended on the application of the current provisions of Treas. Reg. § 1.367(a)-8 to asset reorganizations, and other transactions, that are not addressed in this notice.

SECTION 2. BACKGROUND

Section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person (U.S. transferor) transfers property to a foreign corporation (transferee foreign corporation), such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. Section 367(a)(2), (3) and (6) provides certain exceptions to this general rule and grants regulatory authority to provide additional exceptions and to limit the statutory exceptions.

Exceptions to the general rule of section 367(a)(1) for certain transfers of the stock or securities of a corporation

(transferred corporation) are provided in Treas. Reg. § 1.367(a)-3. In some cases, these exceptions require, among other things, the filing of a gain recognition agreement, as provided in Treas. Reg. § 1.367(a)-8, by the U.S. transferor. Treas. Reg. § 1.367(a)-3(b)(1)(ii) and (c)(1)(iii)(B). Pursuant to a gain recognition agreement, the U.S. transferor agrees, among other things, to include in income the gain realized but not recognized on the initial transfer of the stock or securities, plus interest, upon certain events (triggering events) that occur prior to the close of the fifth full taxable year following the year of the transfer. Treas. Reg. § 1.367(a)-8(b)(1)(iii) and (3)(i).

Treasury Regulation § 1.367(a)-8(e)(1) and (2) provides that dispositions of the stock or securities of the transferred corporation are generally triggering events. Similarly, Treas. Reg. § 1.367(a)-8(e)(3) provides that dispositions of substantially all (within the meaning of section 368(a)(1)(C)) of the assets of the transferred corporation are generally treated as deemed dispositions of the stock or securities of the transferred corporation and therefore are also triggering events. Finally, dispositions of stock of the transferee foreign corporation can also be triggering events. See, e.g., Treas. Reg. § 1.367(a)-8(f)(2)(ii).

Notwithstanding these rules, Treas. Reg. § 1.367(a)-8 provides that certain nonrecognition transactions are not triggering events, if certain requirements are satisfied. For example, Treas. Reg. § 1.367(a)-8(g) provides exceptions for certain transactions involving the U.S. transferor, the transferee foreign corporation, and the transferred corporation. In addition, Treas. Reg. § 1.367(a)-8(f)(2)(i) provides rules to allow taxpayers to enter into a gain recognition agreement in connection with certain transactions, including asset reorganizations, in which the U.S. transferor goes out of existence as a result of a transaction in which the transferor's gain would have qualified for nonrecognition treatment under Treas. Reg. § 1.367(a)-3(b) or (c), had the U.S. transferor remained in existence and entered into a gain recognition agreement. Commentators have stated that although these exceptions clearly contemplate certain nonrecognition transactions, it is not clear whether, and if so how, the exceptions

apply to various asset reorganizations involving the U.S. transferor, the transferee foreign corporation, and the transferred corporation.

Treasury Regulation § 1.367(a)-8 also provides that certain nonrecognition transactions are not triggering events because the gain recognition agreement is terminated and has no further effect. For example, Treas. Reg. § 1.367(a)-8(h)(3) lists certain nonrecognition transactions that terminate the gain recognition agreement, provided that immediately after the transaction the basis in the transferred stock is not greater than the U.S. transferor's basis in the stock that, immediately prior to the initial transfer, necessitated the gain recognition agreement.

Finally, many of the transactions described above may be subject to the provisions of section 367(b) and the regulations thereunder.

SECTION 3. EFFECT OF CERTAIN ASSET REORGANIZATIONS ON GAIN RECOGNITION AGREEMENTS

.01 Definition of the Terms Asset Reorganization, Consolidated Group, and Common Parent

For purposes of sections 3.02 and 4.02 of this notice, the term *asset reorganization* means a reorganization described in section 368(a)(1) involving the transfer of assets by a corporation to another corporation pursuant to section 361, except that such term shall include reorganizations described in section 368(a)(1)(D) or (G) only if the requirements of section 354(b)(1)(A) and (B) are met. For purposes of sections 3.03 and 3.04 of this notice, the term *asset reorganization* has the same meaning as used for sections 3.02 and 4.02 of this notice, except that the following reorganizations are excluded: (1) triangular asset reorganizations described in Treas. Reg. § 1.358-6(b); and (2) asset reorganizations where, after the reorganization, the same corporation is both the transferee foreign corporation (or successor transferee foreign corporation, as applicable) and the transferred corporation (or the successor transferred corporation, as applicable). This may occur, for example, where the transferee foreign corporation transfers all of its assets (including stock of the transferred corporation) to the

transferred corporation pursuant to section 361. However, see section 6 of this notice, requesting comments with respect to those transactions excluded from the definition of an asset reorganization for purposes of sections 3.03 and 3.04 of this notice.

For purposes of this notice, the term *consolidated group* has the same meaning provided in Treas. Reg. § 1.1502-1(h), and the term *common parent* has the same meaning as in section 1504.

.02 Transfers of Transferee Foreign Corporation's Stock by U.S. Transferor

If, during the period a gain recognition agreement is in effect, the original U.S. transferor transfers all or a portion of the stock of the transferee foreign corporation to an acquiring corporation (successor U.S. transferor) pursuant to an asset reorganization, the exchanges made pursuant to such asset reorganization will trigger the gain recognition agreement, unless the following conditions are satisfied:

(A) In the year of the transfer for which the original gain recognition agreement was executed, the U.S. transferor was a member of a consolidated group (original consolidated group), and the common parent of such group (U.S. parent corporation) entered into the original gain recognition agreement pursuant to Treas. Reg. § 1.367(a)-8(a)(3);

(B) Immediately after the asset reorganization, the successor U.S. transferor is a member of the original consolidated group;

(C) The U.S. parent corporation of the original consolidated group (or new U.S. parent corporation, if such corporation became the new common parent of the original consolidated group in a transaction in which the group remained in existence) enters into a new gain recognition agreement pursuant to which it agrees to recognize gain (during the remaining term of the original gain recognition agreement), in accordance with the rules of Treas. Reg. § 1.367(a)-8(b), with respect to the transfer subject to the original gain recognition agreement, modified by substituting the successor U.S. transferor in place of the original U.S. transferor and agreeing to treat the successor U.S. transferor as the original U.S. transferor for purposes of Treas. Reg. § 1.367(a)-8 and this notice; and

(D) The successor U.S. transferor provides with its next annual certification (described in Treas. Reg. § 1.367(a)-8(b)(5)) the new gain recognition agreement and a notice of the transfer setting forth the following:

(i) A description of the transfer (including the date of such transfer), and the successor U.S. transferor's name, address, and taxpayer identification number; and

(ii) A statement that arrangements have been made, in connection with the asset reorganization, ensuring that the successor U.S. transferor will be informed of any subsequent disposition of property with respect to which recognition of gain would be required under the new gain recognition agreement (and any related information that is necessary to comply with Treas. Reg. § 1.367(a)-8 and this notice).

The following example illustrates the application of this section 3.02.

Example 1. (i) Facts. USP, a domestic corporation, is the common parent of a consolidated group. USP owns 100% of the stock of two domestic corporations that are members of the USP group, S1 and S2. S1 owns 100% of two foreign corporations, FC1 and FC2. In Year 1, S1 transfers 100% of the stock of FC1 to FC2 in an exchange described in section 351 and, pursuant to Treas. Reg. §§ 1.367(a)-3(b)(1)(ii) and 1.367(a)-8, USP enters into a gain recognition agreement with respect to such transfer. In Year 4, in a reorganization described in section 368(a)(1)(D), S1 transfers all of its assets, including the stock of FC2, to S2 in exchange for S2 stock. S1 transfers the S2 stock to USP in exchange for the S1 stock held by USP and the S1 stock is canceled. No taxable years of the USP group are short taxable years.

(ii) *Analysis.* Because USP and S2 are, immediately after the reorganization, members of the consolidated group of which S1 was a member, and USP was the common parent which entered into the original gain recognition agreement in year 1 pursuant to Treas. Reg. § 1.367(a)-8(a)(3), the transaction satisfies the requirements of section 3.02(A) and (B) of this notice. As a result, the transfer of the FC2 stock will not trigger the gain recognition agreement if, pursuant to section 3.02 of this notice, USP enters into a new gain recognition agreement, in which it agrees to recognize gain with respect to the transfer subject to the original gain recognition agreement as described in section 3.02(C) of this notice, and S2 complies with the reporting requirements contained in section 3.02(D) of this notice. For purposes of the new gain recognition agreement, Treas. Reg. § 1.367(a)-8, and this notice, S2 is the successor U.S. transferor and is treated as the original U.S. transferor, FC2 continues to be the transferee foreign corporation, and FC1 continues to be the transferred corporation. The new gain recognition agreement applies through the close of Year 6 (the remaining term of the original gain recognition agreement filed by USP).

.03 Transfers of Transferred Corporation's Stock or Securities by Transferee Foreign Corporation to a Foreign Acquiring Corporation

If, during the period a gain recognition agreement is in effect, the original transferee foreign corporation transfers all or a portion of the stock or securities of the transferred corporation to a foreign acquiring corporation (successor transferee foreign corporation) in an asset reorganization, the exchanges made pursuant to such reorganization will trigger the gain recognition agreement, unless the following conditions are satisfied:

(A) The U.S. transferor, U.S. parent corporation or new U.S. parent corporation, as applicable, enters into a new gain recognition agreement pursuant to which it agrees to recognize gain (during the remaining term of the original gain recognition agreement), in accordance with the rules of Treas. Reg. § 1.367(a)-8(b), with respect to the transfer subject to the original gain recognition agreement, substituting the successor transferee foreign corporation in place of the original transferee foreign corporation, and agreeing to treat the successor transferee foreign corporation as the original transferee foreign corporation for purposes of Treas. Reg. § 1.367(a)-8 and this notice; and

(B) The U.S. transferor provides with its next annual certification (described in Treas. Reg. § 1.367(a)-8(b)(5)) the new gain recognition agreement and a notice of the transfer setting forth the following:

(i) A description of the transfer (including the date of such transfer), and the successor transferee foreign corporation's name, address, and taxpayer identification number (if any); and

(ii) A statement that arrangements have been made, in connection with the asset reorganization, ensuring the U.S. transferor will be informed of any subsequent disposition of property with respect to which recognition of gain would be required under the new gain recognition agreement (and any related information that is necessary to comply with Treas. Reg. § 1.367(a)-8 and this notice).

The following example illustrates the application of this section 3.03.

Example 2. (i) Facts. USP, a domestic corporation, owns 100% of the stock of three foreign corporations, FC1, FC2 and FC3. In Year 1, USP transfers

100% of the stock of FC1 to FC2 in an exchange described in section 351 and, pursuant to Treas. Reg. §§ 1.367(a)-3(b)(1)(ii) and 1.367(a)-8, enters into a gain recognition agreement with respect to such transfer. In Year 4, in a reorganization described in section 368(a)(1)(D), FC2 transfers all of its assets, including the stock of FC1, to FC3 in exchange for FC3 stock. FC2 transfers the FC3 stock to USP in exchange for FC2 stock held by USP and the FC2 stock is canceled. No taxable years of USP are short taxable years.

(ii) *Analysis.* Pursuant to section 3.03 of this notice, the transfer of the FC1 stock to FC3 in exchange for FC3 stock and the exchange of the FC2 stock for FC3 stock will not trigger the gain recognition agreement if, in addition to complying with the reporting requirements of section 3.03(B) of this notice, USP enters into a new gain recognition agreement pursuant to which it agrees to recognize gain with respect to the transfer subject to the original gain recognition agreement, substituting FC3 as the successor transferee foreign corporation in place of FC2, and treating FC3 as the original transferee foreign corporation for purposes of Treas. Reg. § 1.367(a)-8 and this notice. Thus, for purposes of the new gain recognition agreement, Treas. Reg. § 1.367(a)-8, and this notice, USP continues to be the U.S. transferor, FC3 is the successor transferee foreign corporation and is treated as the original transferee foreign corporation, and FC1 continues to be the transferred corporation. The new gain recognition agreement applies through the close of year 6 (the remaining term of the original gain recognition agreement filed by USP). This transaction is also subject to the provisions of section 367(b), including Treas. Reg. § 1.367(b)-4.

.04 *Transfers of Substantially All of Transferred Corporation's Assets*

If, during the period a gain recognition agreement is in effect, the original transferred corporation transfers substantially all of its assets to an acquiring corporation (successor transferred corporation) pursuant to an asset reorganization, the exchanges made pursuant to such asset reorganization will trigger the gain recognition agreement, unless the following conditions are satisfied:

(A) The U.S. transferor, U.S. parent corporation, or new U.S. parent corporation, as applicable, enters into a new gain recognition agreement pursuant to which it agrees to recognize gain (during the remaining term of the original gain recognition agreement), in accordance with the rules of Treas. Reg. § 1.367(a)-8(b), with respect to the transfer subject to the original gain recognition agreement, modified by:

(i) Substituting the successor transferred corporation in place of the original transferred corporation and agreeing to treat the successor transferred corporation

as the original transferred corporation for purposes of Treas. Reg. § 1.367(a)-8 and this notice; and

(ii) Treating only the assets acquired by the successor transferred corporation from the original transferred corporation pursuant to the asset reorganization as the assets subject to the deemed disposition of stock rules under Treas. Reg. § 1.367(a)-8(e)(3)(i); and

(B) The U.S. transferor provides with its next annual certification (described in Treas. Reg. § 1.367(a)-8(b)(5)) the new gain recognition agreement and a notice of the transfer setting forth the following:

(i) A description of the transfer (including the date of such transfer), and the successor transferred corporation's name, address, and taxpayer identification number (if any); and

(ii) A statement that arrangements have been made, in connection with the asset reorganization, ensuring the U.S. transferor will be informed of any subsequent disposition of property with respect to which recognition of gain would be required under the new gain recognition agreement (and any related information that is necessary to comply with Treas. Reg. § 1.367(a)-8 and this notice).

The following example illustrates the application of this section 3.04.

Example 3. (i) *Facts.* USP, a domestic corporation, owns 100% of the stock of two foreign corporations, FC1 and FC2. In Year 1, USP transfers 100% of the stock of FC1 to FC2 in an exchange described in section 351 and, pursuant to Treas. Reg. §§ 1.367(a)-3(b)(1)(ii) and 1.367(a)-8, enters into a gain recognition agreement with respect to such transfer. In Year 4, in a reorganization described in section 368(a)(1)(C), FC1 transfers all of its assets to FC3, an unrelated foreign corporation, in exchange for FC3 stock. FC1 transfers the FC3 stock to FC2 in exchange for the FC1 stock held by FC2 and the FC1 stock is canceled. No taxable years of USP are short taxable years.

(ii) *Analysis.* Pursuant to section 3.04 of this notice, the transfer of the FC1 assets to FC3 in exchange for FC3 stock and the exchange of the FC1 stock for FC3 stock will not trigger the gain recognition agreement if, in addition to complying with the reporting requirements of section 3.04(B) of this notice, USP enters into a new gain recognition agreement pursuant to which it agrees to recognize gain with respect to the transfer subject to the original gain recognition agreement, substituting FC3 as the successor transferee corporation in place of FC1, treating FC3 as the original transferred corporation for purposes of Treas. Reg. § 1.367(a)-8 and this notice, and treating only the assets acquired by FC3 from FC1 pursuant to the section 368(a)(1)(C) reorganization as assets subject to the deemed disposition of stock rules under Treas. Reg. § 1.367(a)-8(e)(3)(i). Thus, for purposes

of the new gain recognition agreement, Treas. Reg. § 1.367(a)-8, and this notice, USP continues to be the U.S. transferor, FC2 continues to be the transferee foreign corporation, and FC3 is the successor transferred corporation and is treated as the original transferred corporation. The new gain recognition agreement applies through the close of Year 6 (the remaining term of the original gain recognition agreement filed by USP). This transaction is also subject to the provisions of section 367(b), including Treas. Reg. § 1.367(b)-4.

SECTION 4. OTHER MODIFICATIONS

.01 *Modification of Treas. Reg. § 1.367(a)-8(f)(2)(i)*

For purposes of determining, under Treas. Reg. § 1.367(a)-8(f)(2)(i), whether a U.S. transferor corporation is owned by a single U.S. parent corporation, all members of the U.S. parent corporation's consolidated group for the taxable year that includes the transfer shall be treated as a single corporation.

.02 *Certain Nonrecognition Transfers of Stock of the Transferee Foreign Corporation by the U.S. Transferor under Treas. Reg. § 1.367(a)-8(g)(1)*

If a U.S. transferor disposes of any stock of the transferee foreign corporation in a nonrecognition transfer, other than pursuant to an asset reorganization, the gain recognition agreement will be triggered, unless the U.S. transferor satisfies the requirements of Treas. Reg. § 1.367(a)-8(g)(1), in which case the U.S. transferor will continue to be subject to the terms of the original gain recognition agreement as provided under Treas. Reg. § 1.367(a)-8(g)(1). See section 3.02 of this notice providing rules for asset reorganizations.

.03 *Basis of Transferred Stock for Purposes of Treas. Reg. § 1.367(a)-8(h)(3)*

For purposes of determining whether, immediately following a transaction described in Treas. Reg. § 1.367(a)-8(h)(3), the U.S. transferor's basis in the transferred stock is less than or equal to the basis that it had in the transferred stock immediately prior to the original transfer that necessitated the gain recognition agreement, only the basis in the stock transferred shall be taken into account. Thus, for example, the basis of stock that

is issued (or deemed to be issued) by the transferred corporation to the transferee foreign corporation in connection with subsequent transfers of property from the transferee foreign corporation to the transferred corporation shall not be taken into account.

Example 4. (i) *Facts.* USP, a domestic corporation, owns 100% of the stock of two foreign corporations, FC1 and FC2. In Year 1, USP transfers 100% of the stock of FC1 to FC2 in an exchange described in section 351 and, pursuant to Treas. Reg. §§ 1.367(a)-3(b)(1)(ii) and 1.367(a)-8, enters into a gain recognition agreement with respect to such transfer. In Year 2, FC2 transfers property to FC1 in exchange for newly issued FC1 stock. In Year 4, FC2 distributes all of its FC1 stock to USP in a liquidating distribution that qualifies under sections 332 and 337.

(ii) *Result.* In determining whether the gain recognition agreement entered into by USP is terminated, or in the alternative triggered, only the stock of FC1 transferred by USP to FC2 in Year 1 is considered in determining whether immediately following the section 332 liquidation, USP's basis in the transferred stock is less than or equal to the basis that it had in such stock immediately prior to the initial transfer that necessitated the gain recognition agreement. Thus, the basis in the FC1 stock issued to FC2 in Year 2, in exchange for property, is not taken into account. The result in this example would remain the same if, instead of FC1 actually issuing stock to FC2 in exchange for the transferred property, FC1 was deemed to issue stock to FC2 in exchange for such property.

SECTION 5. EFFECTIVE DATE

Regulations to be issued incorporating the guidance set forth in this notice will apply to gain recognition agreements filed with respect to exchanges of stock or securities occurring on or after September 28, 2005. Until such regulations are issued, taxpayers may rely on this notice. Taxpayers also may apply the provisions of this notice to gain recognition agreements with respect to transfers of stock or securities, for all open years, occurring on or after July 20, 1998 and before September 28, 2005. Taxpayers applying this notice, however, must do so consistently to all transactions within its scope for all open years.

If an exchange that is addressed by this notice occurred on or after July 20, 1998, but prior to September 28, 2005, and the taxpayer chooses to rely on this notice for purposes of such exchange, then the taxpayer shall be treated as having timely satisfied the requirements for filing new gain recognition agreements (and related certifications and reporting), as required by Treas. Reg. § 1.367(a)-8 and described

in section 3 of this notice, if such U.S. person attaches such new gain recognition agreement (and related certifications and reporting) to its timely filed (including extensions) original tax return for the taxable year that includes September 28, 2005.

SECTION 6. COMMENTS

Treasury and the IRS are considering issuing subsequent public guidance that addresses additional issues under Treas. Reg. § 1.367(a)-8. Accordingly, comments are requested regarding the application of Treas. Reg. § 1.367(a)-8, including whether other transactions should be excepted from being treated as triggering events pursuant to rules similar to those contained in this notice. For example, comments are requested as to the most appropriate treatment of asset reorganizations that do not satisfy the conditions described in section 3.02(A) or 3.02(B) of this notice. In addition, comments are requested as to the most appropriate treatment of certain *upstream* and *downstream* reorganizations (including those in which the same corporation becomes both the transferee foreign corporation and transferred corporation, as described in section 3.01 of this notice), and divisive reorganizations qualifying under section 368(a)(1)(D) or (G), involving the U.S. transferor corporation, the foreign transferee corporation, and the transferred corporation. Comments also are requested as to whether rules similar to the rules contained in section 3.03 and 3.04 should apply to triangular reorganizations and, if so, how such rules would apply. Finally, comments are requested as to other transactions which should terminate a gain recognition agreement pursuant to Treas. Reg. § 1.367(a)-8(h)(3) when the stock of the transferred corporation is transferred to the U.S. transferor (or other U.S. person).

Written comments on the issues addressed in this notice may be submitted to the Office of Associate Chief Counsel International, Attention: Notice 2005-74, room 4567, CC:INTL:BR4, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, 20224. Alternatively, taxpayers may submit comments electronically to Notice.Comments@m1.irs.counsel.treas.gov. Comments will be available for public inspection and copying.

SECTION 7. PAPERWORK REDUCTION ACT

Collections of information referenced in this notice have been previously reviewed and approved under control number 1545-1271.

SECTION 8. DRAFTING INFORMATION

The principal author of this notice is Christopher L. Trump of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Christopher L. Trump at (202) 622-3860 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 62, 162, 267, 274; 1.62-2, 1.162-17, 1.267(a)-1, 1.274-5.)

Rev. Proc. 2005-67

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2005-10, 2005-3 I.R.B. 341, and provides rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses, or for meal and incidental expenses, incurred while traveling away from home are deemed substantiated under § 1.274-5 of the Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a *per diem* allowance under a reimbursement or other expense allowance arrangement to pay for the expenses. In addition, this revenue procedure provides an optional method for employees and self-employed individuals who are not reimbursed to use in computing the deductible costs paid or incurred for business meal and incidental expenses, or for incidental expenses only if no meal costs are paid or incurred, while traveling away from home. Use of a method described in this revenue procedure is not mandatory, and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under which the amount of an employee's

lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.

SECTION 2. BACKGROUND AND CHANGES

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct expenses paid or incurred while traveling away from home in pursuit of a trade or business. However, under § 262, no portion of the travel expenses that is attributable to personal, living, or family expenses is deductible.

.02 Section 274(n) generally limits the amount allowable as a deduction under § 162 for any expense for food, beverages, or entertainment to 50 percent of the amount of the expense that otherwise would be allowable as a deduction. In the case of any expenses for food or beverages consumed while away from home (within the meaning of § 162(a)(2)) by an individual during, or incident to, the period of duty subject to the hours of service limitations of the Department of Transportation, § 274(n)(3) gradually increases the deductible percentage to 80 percent for taxable years beginning in 2008. For taxable years beginning in 2005 the deductible percentage for these expenses is 70 percent, and for taxable years beginning in 2006 the deductible percentage for these expenses is 75 percent.

.03 Section 274(d) provides, in part, that no deduction is allowed under § 162 for any travel expense (including meals and lodging while away from home) unless the taxpayer complies with certain substantiation requirements. Section 274(d) further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by the regulations.

.04 Section 1.274-5(g), in part, grants the Commissioner the authority to prescribe rules relating to reimbursement arrangements or *per diem* allowances for ordinary and necessary expenses paid or incurred while traveling away from home. Pursuant to this grant of authority, the

Commissioner may prescribe rules under which these arrangements or allowances, if in accordance with reasonable business practice, will be regarded (1) as equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of travel expenses for purposes of § 1.274-5(c), and (2) as satisfying the requirements of an adequate accounting to the employer of the amount of travel expenses for purposes of § 1.274-5(f).

.05 For purposes of determining adjusted gross income, § 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it —

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein do not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for the expense.

.07 Under § 1.62-2(c)(1) a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62-2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274-5(g) or 1.274-5(j) will be treated as substantiation of the amount of the expenses for purposes of § 1.62-2. Under § 1.62-2(f)(2), the Commissioner may prescribe rules under which an arrangement providing *per diem* allowances is treated as satisfying the requirement of returning amounts in excess of expenses,

even though the arrangement does not require the employee to return the portion of the allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return within a reasonable period of time any portion of the allowance that relates to days of travel not substantiated.

.08 Section 1.62-2(h)(2)(i)(B) provides that, if a payor pays a *per diem* allowance that meets the requirements of § 1.62-2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62-2(e), that exceeds the amount of the employee's expenses deemed substantiated for the travel pursuant to rules prescribed under §§ 274(d) and 1.274-5(g) or 1.274-5(j), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)-3, 31.3231(e)-1(a)(5), 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62-2(g) (relating to the return of excess amounts) do not apply to this portion.

.09 Under § 1.62-2(h)(2)(i)(B)(4), the Commissioner has the discretion to prescribe special rules regarding the timing of withholding and payment of employment taxes on *per diem* allowances.

.10 Section 1.274-5(j)(1) grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for meals paid or incurred while traveling away from home in lieu of substantiating the actual cost of meals.

.11 Section 1.274-5(j)(3) grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for incidental expenses paid or incurred while traveling away from home in lieu of substantiating the actual cost of incidental expenses.

.12 Sections 3.02(1)(a), 4.04(6), and 5.06 of this revenue procedure provide transition rules for the last 3 months of calendar year 2005.

.13 Section 5.02 of this revenue procedure contains revisions to the *per diem* rates for high-cost localities and for other localities for purposes of section 5.

.14 Section 5.03 of this revenue procedure contains the list of high-cost localities and section 5.04 of this revenue procedure describes changes to the list of high-cost localities for purposes of section 5.

SECTION 3. DEFINITIONS

.01 *Per diem allowance*. The term “*per diem* allowance” means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62–2(c)(1) and that is —

(1) paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses, or for meal and incidental expenses, for travel away from home in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at or below the applicable federal *per diem* rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.02 *Federal per diem rate and federal M&IE rate*.

(1) *In general*. The federal *per diem* rate is equal to the sum of the applicable federal lodging expense rate and the applicable federal meal and incidental expense (M&IE) rate for the day and locality of travel.

(a) *CONUS rates*. The rates for localities in the continental United States (“CONUS”) are set forth in Appendix A to 41 C.F.R. ch. 301. However, in applying section 4.01, 4.02, or 4.03 of this revenue procedure, taxpayers may continue to use the CONUS rates in effect for the first 9 months of 2005 for expenses of all CONUS travel away from home that are paid or incurred during calendar year 2005 in lieu of the updated GSA rates. A taxpayer must consistently use either these rates or the updated rates for the period October 1, 2005, through December 31, 2005.

(b) *OCONUS rates*. The rates for localities outside the continental United States (“OCONUS”) are established by the Sec-

retary of Defense (rates for non-foreign localities, including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States) and by the Secretary of State (rates for foreign localities), and are published in the *Per Diem* Supplement to the Standardized Regulations (Government Civilians, Foreign Areas) (updated on a monthly basis).

(c) *Internet access to the rates*. The CONUS and OCONUS rates may be found on the Internet at www.gsa.gov.

(2) *Locality of travel*. The term “locality of travel” means the locality where an employee traveling away from home in connection with the performance of services as an employee of the employer stops for sleep or rest.

(3) *Incidental expenses*. The term “incidental expenses” has the same meaning as in the Federal Travel Regulations, 41 C.F.R. 300–3.1 (2005). Thus, based on the current definition of “incidental expenses” in the Federal Travel Regulations, “incidental expenses” means fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries; transportation between places of lodging or business and places where meals are taken, if suitable meals can be obtained at the temporary duty site; and the mailing cost associated with filing travel vouchers and payment of employer-sponsored charge card billings.

.03 *Flat rate or stated schedule*.

(1) *In general*. Except as provided in section 3.03(2) of this revenue procedure, an allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 3.01 of this revenue procedure. The allowance may be paid with respect to the number of days away from home in connection with the performance of services as an employee or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, an hourly payment to cover meal and incidental expenses paid to a pilot or flight attendant who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule. Likewise, a payment based on the number of miles traveled (such as cents per mile) to cover meal and incidental expenses paid to an

over-the-road truck driver who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

(2) *Limitation*. For purposes of this revenue procedure, an allowance that is computed on a basis similar to that used in computing the employee’s wages or other compensation (such as the number of hours worked, miles traveled, or pieces produced) does not meet the business connection requirement of § 1.62–2(d), is not a *per diem* allowance, and is not paid at a flat rate or stated schedule, unless, as of December 12, 1989, (a) the allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the allowance, or (b) an allowance computed on that basis was commonly used in the industry in which the employee is employed. See § 1.62–2(d)(3)(ii).

SECTION 4. PER DIEM SUBSTANTIATION METHOD

.01 *Per diem allowance*. If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the federal *per diem* rate (see section 3.02 of this revenue procedure) for the locality of travel for that day (or partial day, see section 6.04 of this revenue procedure).

.02 *Meal and incidental expenses only per diem allowance*. If a payor pays a *per diem* allowance only for meal and incidental expenses in lieu of reimbursing actual meals and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the federal M&IE rate for the locality of travel for that day (or partial day). A *per diem* allowance is treated as paid only for meal and incidental expenses if (1) the payor pays the employee for actual expenses for lodging based on receipts submitted to the payor, (2) the payor provides the lodging in kind,

(3) the payor pays the actual expenses for lodging directly to the provider of the lodging, (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee, or (5) the allowance is computed on a basis similar to that used in computing the employee's wages or other compensation (such as the number of hours worked, miles traveled, or pieces produced).

.03 Optional method for meal and incidental expenses only deduction. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who pay or incur meal expenses may use an amount computed at the federal M&IE rate for the locality of travel for each calendar day (or partial day) the employee or self-employed individual is away from home. This amount will be deemed substantiated for purposes of paragraphs (b)(2) and (c) of § 1.274-5, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with those regulations. See section 6.05(1) of this revenue procedure for rules related to the application of the limitation under § 274(n) to amounts determined under this section 4.03. See section 4.05 of this revenue procedure for a method for substantiating incidental expenses that may be used by employees or self-employed individuals who do not pay or incur meal expenses.

.04 Special rules for transportation industry.

(1) *In general.* This section 4.04 applies to (a) a payor that pays a *per diem* allowance only for meal and incidental expenses for travel away from home as described in section 4.02 of this revenue procedure to an employee in the transportation industry, or (b) an employee or self-employed individual in the transportation industry who computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 of this revenue procedure.

(2) *Transportation industry defined.* For purposes of this section 4.04, an employee or self-employed individual is in the transportation industry only if the employee's or individual's work (a) is of the

type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing federal M&IE rates. For purposes of the preceding sentence, a payor must determine that an employee or a group of employees is in the transportation industry by using a method that is consistently applied and in accordance with reasonable business practice.

(3) *Rates.* A taxpayer described in section 4.04(1) of this revenue procedure may treat \$52 as the federal M&IE rate for any CONUS locality of travel, and \$58 as the federal M&IE rate for any OCONUS locality of travel. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts subject to section 4.02 of this revenue procedure paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. Similarly, an employee or self-employed individual that uses either (or both) of these special rates must use the special rate(s) for all amounts computed pursuant to section 4.03 of this revenue procedure for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. See section 4.04(6) of this revenue procedure for transition rules.

(4) *Periodic rule.* A payor described in section 4.04(1) of this revenue procedure may compute the amount of the employee's expenses that is deemed substantiated under section 4.02 of this revenue procedure periodically (not less frequently than monthly), rather than daily, by comparing the total *per diem* allowance paid for the period to the sum of the amounts computed either at the federal M&IE rate(s) for the localities of travel, or at the special rate described in section 4.04(3), for the days (or partial days) the employee is away from home during the period.

(5) *Examples.*

(a) *Example 1.* Taxpayer, an employee in the transportation industry, travels away from home on business within CONUS on 17 days (including partial days) during a calendar month and receives a *per diem* allowance only for meal and incidental expenses from a payor that uses the special rule under section 4.04(3) of this revenue procedure. The amount deemed substantiated under section 4.02 of this revenue procedure is equal to the lesser of the total *per*

diem allowance paid for the month or \$884 (17 days at \$52 per day).

(b) *Example 2.* Taxpayer, a truck driver employee in the transportation industry, is paid a "cents-per-mile" allowance that qualifies as an allowance paid under a flat rate or stated schedule as defined in section 3.03 of this revenue procedure. Taxpayer travels away from home on business for 10 days. Based on the number of miles driven by Taxpayer, Taxpayer's employer pays an allowance of \$500 for the 10 days of business travel. Taxpayer actually drives for 8 days, and does not drive for the other 2 days Taxpayer is away from home. Taxpayer is paid under the periodic rule used for transportation industry employers and employees in accordance with section 4.04(4) of this revenue procedure. The amount deemed substantiated and excludable from Taxpayer's income is the full \$500 because that amount does not exceed \$520 (ten days away from home at \$52 per day).

(6) *Transition rules.* Under the calendar-year convention provided in section 4.04(3), a taxpayer who used the federal M&IE rates during the first 9 months of calendar year 2005 to substantiate the amount of an individual's travel expenses under sections 4.02 or 4.03 of Rev. Proc. 2005-10 may not use, for that individual, the special transportation industry rates provided in this section 4.04 until January 1, 2006. Similarly, a taxpayer who used the special transportation industry rates during the first 9 months of calendar year 2005 to substantiate the amount of an individual's travel expenses may not use, for that individual, the federal M&IE rates until January 1, 2006.

.05 Optional method for incidental expenses only deduction. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who do not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may use, for each calendar day (or partial day) the employee or self-employed individual is away from home, an amount computed at the rate of \$3 per day for any CONUS or OCONUS locality of travel. This amount will be deemed substantiated for purposes of paragraphs (b)(2) and (c) of § 1.274-5, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with those regulations. See section 4.03 of this revenue procedure for a method that may be used by employees or self-employed individuals who pay or incur meal expenses. The method

authorized by this section 4.05 may not be used by payors that use section 4.01, 4.02, or 5.01 of this revenue procedure, or by employees or self-employed individuals who use the method described in section 4.03 of this revenue procedure. See section 6.05(4) of this revenue procedure for rules related to the application of the limitation under § 274(n) to amounts determined under this section 4.05.

SECTION 5. HIGH-LOW SUBSTANTIATION METHOD

.01 *In general.* If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home and the payor uses the high-low substantiation method described in this section 5 for travel within

CONUS, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the *per diem* allowance for that day or the amount computed at the rate set forth in section 5.02 of this revenue procedure for the locality of travel for that day (or partial day, see section 6.04 of this revenue procedure). Except as provided in section 5.06 of this revenue procedure, this high-low substantiation method may be used in lieu of the *per diem* substantiation method provided in section 4.01 of this revenue procedure, but may not be used in lieu of the meals only substantiation method provided in section 4.02 of this revenue procedure.

.02 *Specific high-low rates.* Except as provided in section 5.06 of this revenue procedure, the *per diem* rate for purposes of this section 5 is \$226 for travel to any

“high-cost locality” specified in section 5.03 of this revenue procedure, or \$141 for travel to any other locality within CONUS. The high or low rate, as appropriate, applies as if it were the federal *per diem* rate for the locality of travel. For purposes of applying the high-low substantiation method and the § 274(n) limitation on meal expenses (see section 6.05(3) of this revenue procedure), the amount of the high and low rates that is treated as paid for meals is \$58 for a high-cost locality and \$45 for any other locality within CONUS.

.03 *High-cost localities.* The following localities have a federal *per diem* rate of \$184 or more, and are high-cost localities for all of the calendar year or the portion of the calendar year specified in parentheses under the key city name:

<i>Key City</i>	<i>County or other defined location</i>
Arizona	
Phoenix/Scottsdale (January 1-March 31)	Maricopa
California	
Napa	Napa
San Diego	San Diego
San Francisco	San Francisco
Santa Monica	City limits of Santa Monica
Colorado	
Aspen (December 1-March 31)	Pitkin
Crested Butte/Gunnison (December 1-April 30)	Gunnison
Silverthorne/Breckenridge (December 1-March 31)	Summit
Steamboat Springs (December 1-March 31)	Routt
Telluride (October 1-April 30)	San Miguel
Vail (December 1-March 31)	Eagle
District of Columbia	
Washington D.C. (also the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington, Loudoun, and Fairfax, in Virginia; and the counties of Montgomery and Prince George’s in Maryland) (See also Maryland and Virginia)	
Florida	
Key West	Monroe

<i>Key City</i>	<i>County or other defined location</i>
Miami (January 1-April 30)	Miami-Dade
Naples (February 1-March 31)	Collier
Palm Beach (February 1-March 31)	Boca Raton, Delray Beach, Jupiter, Palm Beach Gardens, Palm Beach, Palm Beach Shores, Singer Island and West Palm Beach
Illinois	
Chicago (October 1-June 30 and September 1-September 30)	Cook and Lake
Louisiana	
New Orleans (October 1-May 31)	Orleans, St. Bernard, Jefferson, and Plaquemine Parishes
Maine	
Bar Harbor (July 1-August 31)	Hancock
Maryland	
(For the counties of Montgomery and Prince George's, see District of Columbia)	
Baltimore	Baltimore County and Baltimore City
Cambridge/St. Michaels (June 1-August 31)	Dorchester and Talbot
Ocean City (June 1-September 30)	Worcester
Massachusetts	
Boston/Cambridge	Suffolk, City of Cambridge
Martha's Vineyard (July 1-August 31)	Dukes
Nantucket (June 1-August 31)	Nantucket
New Hampshire	
Conway (July 1-August 31)	Carroll
New Jersey	
Cape May/Ocean City (July 1-August 31)	Cape May
New York	
Floral Park/Garden City/Glen Cove/Great Neck/Roslyn	Nassau
Lake Placid (July 1-August 31)	Essex

<i>Key City</i>	<i>County or other defined location</i>
Manhattan	Boroughs of Manhattan, Brooklyn, Queens, the Bronx and Staten Island
Riverhead/Ronkonkoma/ Melville/ Smithtown/Huntington Station/ Amagansett/East Hampton/ Montauk/Southampton/ Islandia/Commack/Medford/ Stony Brook/Hauppauge/ Centereach	Suffolk
Saratoga Springs/Schenectady (July 1-August 31)	Saratoga and Schenectady
Tarrytown/White Plains/New Rochelle/Yonkers	Westchester
Pennsylvania	
Philadelphia	Philadelphia
Rhode Island	
Jamestown/Middletown/ Newport (October 1-October 31 and May 1-September 30)	Newport
Providence	Providence
Utah	
Park City (December 1-March 31)	Summit
Washington	
Seattle	King

.04 *Changes in high-cost localities.* The list of high-cost localities in section 5.03 of this revenue procedure differs from the list of high-cost localities in section 5.03 of Rev. Proc. 2005-10 (changes listed by key cities).

(1) The following localities have been added to the list of high-cost localities: Steamboat Springs, Colorado; Bar Harbor, Maine; Conway, New Hampshire; and Saratoga Springs/Schenectady, New York.

(2) The portion of the year for which the following are high-cost localities has been changed: Phoenix/Scottsdale, Arizona; Napa, California; Aspen, Colorado; Crested Butte/Gunnison, Colorado; Telluride, Colorado; Vail, Colorado; Miami, Florida; Naples, Florida; Palm Beach, Florida; Chicago, Illinois; New Orleans, Louisiana; Ocean City, Maryland; Martha's Vineyard, Massachusetts; Nan-

tucket, Massachusetts; Cape May/Ocean City, New Jersey; and Seattle, Washington.

(3) The following localities have been removed from the list of high-cost localities: Monterey, California; Palm Springs, California; Santa Barbara, California; South Lake Tahoe, California; Lewes, Delaware; Daytona Beach, Florida; Fort Lauderdale, Florida; Hyannis, Massachusetts; Traverse City, Michigan; Atlantic City, New Jersey; Princeton/Trenton, New Jersey; Santa Fe, New Mexico; Kill Devil, North Carolina; Hershey, Pennsylvania; Hilton Head, South Carolina; and Virginia Beach, Virginia.

(4) The following localities have been redefined: New Orleans, Louisiana has added the parishes of Jefferson and Plaquemine; Boston, Massachusetts and Cambridge, Massachusetts are one

locality; Cape May, New Jersey and Ocean City, New Jersey are one locality; Carle Place/Plainview/Rockville Centre/Syosset/Uniondale/ Woodbury have been removed from, and Floral Park/Roslyn have been added to, Nassau County, New York; Smithtown/Huntington Station/Amagansett/East Hampton/Montauk/Southampton/Islandia/Commack/Medford/Stony Brook/Hauppauge/Centereach have been added to Suffolk County, New York; and White Plains, Tarrytown, New Rochelle, and Yonkers are combined as Westchester County, New York.

.05 *Specific limitation.*

(1) Except as provided in section 5.05(2) of this revenue procedure, a payor that uses the high-low substantiation method with respect to an employee must use that method for all amounts paid

to that employee for travel away from home within CONUS during the calendar year. See section 5.06 of this revenue procedure for transition rules.

(2) With respect to an employee described in section 5.05(1) of this revenue procedure, the payor may reimburse actual expenses or use the meals only *per diem* method described in section 4.02 of this revenue procedure for any travel away from home, and may use the *per diem* substantiation method described in section 4.01 of this revenue procedure for any OCONUS travel away from home.

.06 *Transition rules.* A payor who used the substantiation method of section 4.01 of Rev. Proc. 2005–10 for an employee during the first 9 months of calendar year 2005 may not use the high-low substantiation method in section 5 of this revenue procedure for that employee until January 1, 2006. A payor who used the high-low substantiation method of section 5 of Rev. Proc. 2005–10 for an employee during the first 9 months of calendar year 2005 must continue to use the high-low substantiation method for the remainder of calendar year 2005 for that employee. A payor described in the previous sentence may use the rates and high-cost localities published in section 5 of Rev. Proc. 2005–10, in lieu of the updated rates and high-cost localities provided in section 5 of this revenue procedure, for travel on or after October 1, 2005, and before January 1, 2006, if those rates and localities are used consistently during this period for all employees reimbursed under this method.

SECTION 6. LIMITATIONS AND SPECIAL RULES

.01 *In general.* The federal *per diem* rate and the federal M&IE rate described in section 3.02 of this revenue procedure for the locality of travel will be applied in the same manner as applied under the Federal Travel Regulations, 41 C.F.R. Part 301–11 (2005), except as provided in sections 6.02 through 6.04 of this revenue procedure.

.02 *Federal per diem rate.* A receipt for lodging expenses is not required in determining the amount of expenses deemed substantiated under section 4.01 or 5.01 of this revenue procedure. See section 7.01 of this revenue procedure for the requirement that the employee substantiate the

time, place, and business purpose of the expense.

.03 *Federal per diem or M&IE rate.* A payor is not required to reduce the federal *per diem* rate or the federal M&IE rate for the locality of travel for meals provided in kind, provided the payor has a reasonable belief that meal and incidental expenses were or will be incurred by the employee during each day of travel.

.04 *Proration of the federal per diem or M&IE rate.* Pursuant to the Federal Travel Regulations, in determining the federal *per diem* rate or the federal M&IE rate for the locality of travel, the full applicable federal M&IE rate is available for a full day of travel from 12:01 a.m. to 12:00 midnight. The method described in section 6.04(1) of this revenue procedure must be used for purposes of determining the amount deemed substantiated under section 4.03 or 4.05 of this revenue procedure for partial days of travel away from home. For purposes of determining the amount deemed substantiated under section 4.01, 4.02, 4.04, or 5 of this revenue procedure for partial days of travel away from home, either of the following methods may be used to prorate the federal M&IE rate to determine the federal *per diem* rate or the federal M&IE rate for the partial days of travel:

(1) The rate may be prorated using the method prescribed by the Federal Travel Regulations. Currently the Federal Travel Regulations allow three-fourths of the applicable federal M&IE rate for each partial day during which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual. The same ratio may be applied to prorate the allowance for incidental expenses described in section 4.05 of this revenue procedure; or

(2) The rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to two times the federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only one and a half times the federal M&IE rate would be allowed under the Federal Travel Regulations).

.05 *Application of the appropriate § 274(n) limitation on meal expenses.* Except as provided in section 6.05(4), all or part of the amount of an expense deemed substantiated under this revenue procedure is subject to the appropriate limitation under § 274(n) (see section 2.02 of this revenue procedure) on the deductibility of food and beverage expenses.

(1) If an amount for meal and incidental expenses is computed pursuant to section 4.03 of this revenue procedure, the taxpayer must treat that amount as an expense for food and beverages.

(2) If a *per diem* allowance is paid only for meal and incidental expenses, the payor must treat an amount equal to the lesser of the allowance or the federal M&IE rate for the locality of travel for each day (or partial day, see section 6.04 of this revenue procedure) as an expense for food and beverages.

(3) If a *per diem* allowance is paid for lodging, meal, and incidental expenses, the payor must treat an amount equal to the federal M&IE rate for the locality of travel for each calendar day (or partial day) the employee is away from home as an expense for food and beverages. For purposes of the preceding sentence, if a *per diem* allowance for lodging, meal, and incidental expenses is paid at a rate that is less than the federal *per diem* rate for the locality of travel for each day (or partial day), the payor may treat an amount equal to 40 percent of the allowance as the federal M&IE rate for the locality of travel for each day (or partial day).

(4) If an amount for incidental expenses is computed under section 4.05 of this revenue procedure, none of the amount so computed is subject to limitation under § 274(n) on the deductibility of food and beverage expenses.

.06 *No double reimbursement or deduction.* If a payor pays a *per diem* allowance in lieu of reimbursing actual lodging, meal, and incidental expenses or for meal and incidental expenses in accordance with section 4 or 5 of this revenue procedure, any additional payment with respect to those expenses is treated as paid under a nonaccountable plan, is included in the employee's gross income, is reported as wages or other compensation on the employee's Form W-2, "Wage and Tax Statement," and is subject to withholding and payment of employment taxes.

Similarly, if an employee or self-employed individual computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 or 4.04 of this revenue procedure, no other deduction is allowed to the employee or self-employed individual with respect to those expenses. For example, assume an employee receives a *per diem* allowance from a payor for lodging, meal, and incidental expenses, or for meal and incidental expenses, incurred while traveling away from home. During that trip, the employee pays for dinner for the employee and two business associates. The payor reimburses as a business entertainment meal expense the meal expense for the employee and the two business associates. Because the payor also pays a *per diem* allowance to cover the cost of the employee's meals, the amount paid by the payor for the employee's portion of the business entertainment meal expense is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes.

.07 *Related parties.* Sections 4.01 and 5 of this revenue procedure do not apply if a payor and an employee are related within the meaning of § 267(b), but for this purpose the percentage of ownership interest referred to in § 267(b)(2) is 10 percent.

SECTION 7. APPLICATION

.01 If the amount of travel expenses is deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure, and the employee substantiates to the payor the elements of time, place, and business purpose of the travel for that day (or partial day) in accordance with paragraphs (b)(2) and (c) (other than subparagraph (2)(iii)(A) thereof) of § 1.274-5, the employee is deemed to satisfy the adequate accounting requirements of § 1.274-5(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274-5(c). See § 1.62-2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.02 An arrangement providing *per diem* allowances will be treated as satisfying the

requirement of § 1.62-2(f)(2) of returning amounts in excess of expenses if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) any portion of the allowance that relates to days of travel not substantiated, even though the arrangement does not require the employee to return the portion of the allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance *per diem* allowance for meal and incidental expenses of \$250, based on an anticipated 5 days of business travel at \$50 per day to a locality for which the federal M&IE rate is \$39, and the employee substantiates 3 full days of business travel. The requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) the portion of the allowance that is attributable to the 2 unsubstantiated days of travel (\$100), even though the employee is not required to return the portion of the allowance (\$33) that exceeds the amount of the employee's expenses deemed substantiated under section 4.02 of this revenue procedure (\$117) for the 3 substantiated days of travel. However, the \$33 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 7.04 of this revenue procedure.

.03 An employee is not required to include in gross income the portion of a *per diem* allowance received from a payor that is less than or equal to the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the *per diem* allowance in accordance with section 7.01 of this revenue procedure. See § 1.274-5(f)(2)(i). In addition, that portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W-2, and is exempt from the withholding and payment of employment taxes. See § 1.62-2(c)(2) and (c)(4).

.04 An employee is required to include in gross income only the portion of the *per diem* allowance received from a payor that exceeds the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee

substantiates the business travel expenses covered by the *per diem* allowance in accordance with section 7.01 of this revenue procedure. See § 1.274-5(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. See § 1.62-2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.05 If the amount of the expenses that is deemed substantiated under the rules provided in section 4.01, 4.02, or 5 of this revenue procedure is less than the amount of the employee's business expenses for travel away from home, the employee may claim an itemized deduction for the amount by which the business travel expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business travel expenses, includes on Form 2106, "*Employee Business Expenses*," the deemed substantiated portion of the *per diem* allowance received from the payor, and includes in gross income the portion (if any) of the *per diem* allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274-5(f)(2)(iii). However, for purposes of claiming this itemized deduction with respect to meal and incidental expenses, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the amount computed under section 4.03 of this revenue procedure minus the amount deemed substantiated under sections 4.02 and 7.01 of this revenue procedure. The itemized deduction is subject to the appropriate limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.06 An employee who pays or incurs amounts for meal expenses and does not receive a *per diem* allowance for meal and incidental expenses may deduct an amount computed pursuant to section 4.03 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the appropriate limitation on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67. See section 7.07 of this revenue pro-

cedure for the treatment of an employee who does not pay or incur amounts for meal expenses and does not receive a *per diem* allowance for incidental expenses.

.07 An employee who does not pay or incur amounts for meal expenses and does not receive a *per diem* allowance for incidental expenses may deduct an amount computed pursuant to section 4.05 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67. See section 7.06 of this revenue procedure for the treatment of an employee who pays or incurs amounts for meal expenses and does not receive a *per diem* allowance for meal and incidental expenses.

.08 A self-employed individual who pays or incurs meal expenses for a calendar day (or partial day) of travel away from home may deduct an amount computed pursuant to section 4.03 of this revenue procedure in determining adjusted gross income under § 62(a)(1). This deduction is subject to the appropriate limitation on meal and entertainment expenses provided in § 274(n).

.09 A self-employed individual who does not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may deduct an amount computed pursuant to section 4.05 of this revenue procedure in determining adjusted gross income under § 62(a)(1).

.10 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. See § 1.62-2(k). Thus, these payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62-2(c)(3), (c)(5), and (h)(2).

SECTION 8. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a *per diem* allowance, if any, that relates to the days

of business travel substantiated and that exceeds the amount deemed substantiated for those days under section 4.01, 4.02, or 5 of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

.02 In the case of a *per diem* allowance paid as a reimbursement, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days of travel substantiated. See § 1.62-2(h)(2)(i)(B)(2).

.03 In the case of a *per diem* allowance paid as an advance, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the days of travel with respect to which the advance was paid are substantiated. See § 1.62-2(h)(2)(i)(B)(3). If some or all of the days of travel with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those days within a reasonable period of time, the portion of the allowance that relates to those days is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

.04 In the case of a *per diem* allowance only for meal and incidental expenses for travel away from home paid to an employee in the transportation industry by a payor that uses the rule in section 4.04(4) of this revenue procedure, the excess of the *per diem* allowance paid for the period over the amount deemed substantiated for the period under section 4.02 of this revenue procedure (after applying section 4.04(4) of this revenue procedure), is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62-2(h)(2)(i)(B)(4).

.05 For example, assume that an employer pays an employee a *per diem* allowance to cover business expenses for

meals and lodging for travel away from home at a rate of 120 percent of the federal *per diem* rate for the localities to which the employee travels. The employer does not require the employee to return the 20 percent by which the reimbursement for those expenses exceeds the federal *per diem* rate. The employee substantiates 6 days of travel away from home: 2 days in a locality in which the federal *per diem* rate is \$160 and 4 days in a locality in which the federal *per diem* rate is \$120. The employer reimburses the employee \$960 for the 6 days of travel away from home (2 x (120% x \$160) + 4 x (120% x \$120)), and does not require the employee to return the excess payment of \$160 (2 days x \$32 (\$192-\$160) + 4 days x \$24 (\$144-\$120)). For the payroll period in which the employer reimburses the expenses, the employer must withhold and pay employment taxes on \$160. See section 8.02 of this revenue procedure.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for *per diem* allowances for lodging, meal and incidental expenses, or for meal and incidental expenses only, that are paid to an employee on or after October 1, 2005, with respect to travel away from home on or after October 1, 2005. For purposes of computing the amount allowable as a deduction for travel away from home, this revenue procedure is effective for meal and incidental expenses or for incidental expenses only paid or incurred on or after October 1, 2005.

SECTION 10. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2005-10 is superseded.

DRAFTING INFORMATION

The principal author of this revenue procedure is Christian Wood of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Wood at (202) 622-4930 (not a toll-free call).

Part IV. Items of General Interest

Withdrawal of Notice of Proposed Rulemaking; Notice of Proposed Rulemaking; and Notice of Public Hearing

Source of Income From Certain Space and Ocean Activities; Source of Communications Income

REG-106030-98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking; notice of proposed rulemaking; and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 863(d) governing the source of income from certain space and ocean activities. It also contains proposed regulations under section 863(a), (d), and (e) governing the source of income from certain communications activities. This document also contains proposed regulations under section 863(a) and (b), amending the regulations in §1.863-3 to conform those regulations to these proposed regulations. This document affects persons who derive income from activities conducted in space, or on or under water not within the jurisdiction of a foreign country, possession of the United States, or the United States (in international water). This document also affects persons who derive income from transmission of communications. In addition, this document provides notice of a public hearing on these proposed regulations and withdraws the notice of proposed rulemaking (66 FR 3903) published in the **Federal Register** on January 17, 2001.

DATES: Written or electronic comments must be received by November 23, 2005. Outlines of topics to be discussed at the public hearing scheduled for December 15, 2005, at 10 a.m., must be received by November 23, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-106030-98), room

5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-106030-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via either the IRS Internet site at www.irs.gov/regs or the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-106030-98). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Edward R. Barret, (202) 622-3880; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Cynthia Grigsby, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1718.

The collection of information in these proposed regulations is in §§1.863-8(g) and 1.863-9(g). This information is required by the IRS to monitor compliance with the Federal tax rules for determining the source of income from space or ocean activities, or from transmission of communications.

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

Books or records relating to a collection of information must be retained as long as their contents may become material in

the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Congress enacted section 863(d) and (e) as part of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085) (the 1986 Act). Section 863(d) governs the source of income derived from certain space and ocean activities. Section 863(e) governs the source of income derived from international communications activity.

On January 17, 2001, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-106030-98, 2001-1 C.B. 820) in the **Federal Register** (66 FR 3903) under section 863(a), (b), (d), and (e) (the 2001 proposed regulations). The 2001 proposed regulations provide two sets of rules, one in §1.863-8 for determining the source of income from space and ocean activities (space and ocean income), the other in §1.863-9 for determining the source of income from communications activity (communications income).

The IRS received numerous written comments on the 2001 proposed regulations and held a public hearing on May 23, 2001. Since that time, the aerospace, telecommunications, and related industries have experienced substantial technological evolution and significant business change and consolidation. In addition, the American Jobs Creation Act of 2004, Public Law 108-357, (AJCA) enacted a number of materially relevant statutory changes that affect the treatment of space and ocean income for purposes of the foreign tax credit and subpart F. In light of the extensive written comments, industry evolution, and AJCA changes, the Treasury Department and the IRS believe it is appropriate to repropose these regulations to provide a further opportunity for comment. Accordingly, this document withdraws the 2001 proposed regulations and provides new proposed regulations, which are referred to herein as the repropose regulations.

Explanation of Provisions

A. Space and Ocean Activity under Section 863(d)

1. Space and ocean income

Section 863(d)(2)(A)(i) defines space activity to include any activity conducted in space. Section 863(d)(2)(A)(ii) defines ocean activity to include any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States. Section 863(d)(2)(B) excludes three specific types of activities from the definition of space or ocean activity. Section 863(d)(1) generally provides that, except as provided in regulations, any income derived from a space or ocean activity (space and ocean income) is U.S. source income if derived by a U.S. person and foreign source income if derived by a foreign person.

Pursuant to the statute's grant of regulatory authority, the repropounded regulations provide that a U.S. person's space and ocean income will be sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. This approach to allocation of space and ocean income between U.S. and foreign sources is pursuant to broad regulatory authority in section 863(d). The repropounded regulations also contain certain exceptions to the general foreign source rule for space and ocean income of foreign persons.

2. Space and ocean income of U.S.-owned foreign corporation

Section 1.863-8(b)(2) of the 2001 proposed regulations provides that if U.S. persons own 50 percent or more of a foreign corporation by vote or value (directly, indirectly, or constructively) and such corporation is not a controlled foreign corporation within the meaning of section 957 (CFC), all space and ocean income derived by the corporation (hereinafter a U.S.-owned foreign corporation) is U.S. source income.

Several commentators requested that §1.863-8(b)(2) of the 2001 proposed regulations be withdrawn. Commentators stated that the rule expanded the scope

of U.S. taxing jurisdiction beyond the apparent intent of Congress by subjecting income not covered by subpart F to immediate U.S. taxation. Several commentators also stated that under the rule space and ocean income could in some cases be subject to multiple levels of taxation. In this regard, some commentators noted that the space and ocean income of a U.S.-owned foreign corporation could be subject to potential double taxation at the corporate level (by the United States and by the U.S.-owned foreign corporation's country of residence or the countries where such corporation does business) because §1.863-8(b)(2) of the 2001 proposed regulations makes such space and ocean income U.S. source. When the U.S.-owned foreign corporation's space and ocean income is distributed as a dividend, that income could be subject to an additional level of tax in the hands of its shareholders. Consequently, some commentators suggested that, if the rule were retained, the space and ocean income of U.S.-owned foreign corporations should be considered U.S. source solely for purposes of the U.S. shareholder's foreign tax credit limitation under section 904(a). Some commentators noted that although section 245 may partially ameliorate this situation by providing a dividends received deduction (DRD) to shareholders of foreign corporations in certain circumstances, the DRD would be limited to 80 percent of qualifying dividends.

Some commentators also noted potential withholding tax issues with the source rules for U.S.-owned foreign corporations. In such cases, U.S. source fixed or determinable annual or periodic income (FDAP) of a U.S.-owned foreign corporation would (in the absence of an applicable treaty) likely be subject to the 30-percent gross income tax imposed by section 881, which is typically collected through withholding by the payors of such income. Commentators stated that enforcement and administration of the 30-percent tax and withholding requirements could present multiple challenges (and potential multiple withholding tax obligations) for payments between foreign persons.

Several commentators addressed the stock ownership test applicable to U.S.-owned foreign corporations. They stated that determining whether a foreign

corporation is 50-percent U.S.-owned, especially without regard to the size of an owner's holding, presents potential difficulties (for example, when the foreign corporation is widely-held). Some commentators stated that the indirect and constructive ownership rules are complex and would make it difficult for payors of space and ocean income to determine withholding tax obligations. Some commentators suggested that if the rule were retained, the determination whether a foreign corporation is 50-percent U.S.-owned should be similar to the determination of CFC status, that is, only U.S. persons who own or are considered to own 10 percent or more of the total combined voting power of all classes of stock entitled to vote should be counted. Some commentators stated that the rule should not apply to publicly-traded foreign corporations.

In light of the potential complexity in determining whether a foreign corporation is a U.S.-owned foreign corporation and the belief of the Treasury Department and the IRS that space and ocean income earned by foreign corporations should be sourced in accord with the rules for foreign persons, with the limited exception for certain CFCs discussed below, the repropounded regulations do not include a special source rule for space and ocean income earned by a U.S.-owned foreign corporation. Instead, the space and ocean income of foreign corporations (other than CFCs) is sourced under the applicable provisions of repropounded §1.863-8(b)(2)(i) or (iii). Under these provisions, space and ocean income of a foreign person is generally foreign source income. Space and ocean income of a foreign person (other than a CFC) that is engaged in trade or business within the United States is U.S. source income to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

3. Space and ocean income of CFCs

In enacting section 863(d), Congress ultimately did not adopt a provision included in early versions of the legislation that would have treated a CFC as a U.S. person for purposes of determining the source of a CFC's space and ocean income. The legislative history to the 1986

Act indicates that Congress at that time viewed the provision as unnecessary because “[t]he application of the separate foreign tax credit limitation for shipping income to any space or ocean income derived by a [CFC] provides adequate assurance, in the conferee’s view, that high foreign taxes on unrelated income will not inappropriately offset U.S. taxes on this generally low-taxed income.” H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess., Vol. II, at II-600 (Sept. 18, 1986); see also Staff of Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 934 (May 4, 1987). Consequently, the 2001 proposed regulations also did not contain such a rule and only treated a U.S.-owned foreign corporation as a U.S. person for purposes of determining the source of space and ocean income.

In 2004, AJCA enacted a number of significant statutory changes to subpart F and the foreign tax credit regimes as applicable to space and ocean income. These statutory changes have been taken into account in issuing the repropoed regulations.

Section 415 of AJCA eliminated foreign base company shipping income from the definition of foreign base company income. This change is effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years with or within which such taxable years of foreign corporations end. Prior to AJCA, foreign base company shipping income was defined by section 954(f) to include any income derived from a space or ocean activity as defined in section 863(d)(2).

In addition, section 404 of AJCA reduced the number of foreign tax credit limitation categories from nine to two (*i.e.*, passive category income and general category income) in order to address Congressional concerns regarding the complexity of the foreign tax credit calculation. See H.R. Rep. No 108-548, 108th Cong., 2d Sess., at 190 (June 16, 2004). This change is effective for taxable years beginning after December 31, 2006. Prior to AJCA, section 904(d) treated shipping income, defined as income “which would be foreign base company shipping income (as defined in section 954(f)),” as a separate category of income for foreign tax credit limitation purposes. For taxable years beginning after December 31, 2006, space

and ocean income will generally fall into the general limitation category. See H.R. Conf. Rep. No. 108-755, 108th Cong., 2d Sess., at 383 (Oct. 7, 2004).

The Treasury Department and the IRS believe that the changes made by AJCA with respect to the foreign tax credit reflect a decision to reduce the complexity in the foreign tax credit calculation caused by having nine foreign tax credit categories of income as well as a willingness to allow additional cross-crediting in order to minimize such complexity. However, the Treasury Department and the IRS also believe that for taxable years beginning after December 31, 2006, Congress’s concern expressed in the 1986 Act that high foreign taxes on unrelated income may inappropriately offset U.S. taxes on space and ocean income, which is generally subject to low foreign taxes, is no longer addressed by the foreign tax credit rules because space and ocean income likely will be general limitation category income. In addition, Congress provided a broad grant of regulatory authority to the Treasury Department and the IRS in section 863(d) to issue guidance with respect to the source of space and ocean income.

In light of AJCA, the repropoed regulations provide that if a foreign corporation is a CFC, its space and ocean income, like that of a U.S. person, is income from sources within the United States. However, a CFC’s space and ocean income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. This allocation approach is pursuant to broad regulatory authority under section 863(d).

As noted above, several commentators stated that under the rule for U.S.-owned foreign corporations in the 2001 proposed regulations, space and ocean income could in some cases be subject to multiple levels of taxation. The Treasury Department and the IRS believe that the repropoed regulations mitigate such a possibility for CFCs because the repropoed regulations provide for foreign sourcing when a CFC’s space and ocean income is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. The rule for CFCs in the repropoed regulations is thus a rule of limited

application that, consistent with the legislative history of the 1986 Act, provides U.S. source treatment only with respect to space and ocean income attributable to activities in space or international water that are not likely to be subject to tax in any foreign country. The rule for CFCs will permit a United States shareholder to establish as foreign source the amount of income attributable to the CFC’s operations in a foreign country or countries.

Several commentators submitted comments on potential withholding tax issues posed by the 2001 proposed regulations. The Treasury Department and the IRS recognize that certain provisions of the repropoed regulations (such as the source rule for the space and ocean income of CFCs in repropoed §1.863-8(b)(2)(ii)) may raise similar withholding tax issues. The Treasury Department and the IRS accordingly seek comments on these issues, in particular with regard to the following: (1) the extent to which Form W-8ECI, “*Certificate of Foreign Person’s Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States*”, may practically address these issues; (2) the nature of situations in which withholding tax issues will arise (for example, how particular businesses involving space, ocean, or communications activities are conducted, whether payors of income potentially subject to withholding under the repropoed regulations are typically related or unrelated parties, etc.); and (3) suggestions to address these issues in the cases in which they arise.

4. *Space and ocean income of a foreign person engaged in a trade or business within the United States*

Section 1.863-3(b)(3) of the 2001 proposed regulations provides that if a foreign person is engaged in a trade or business within the United States, the foreign person’s income derived from a space or ocean activity is presumed to be U.S. source income. The rule reflects the general view of the Treasury Department and the IRS that Congress intended that a foreign person engaged in a substantial business within the United States be subject to U.S. tax on related space or ocean income. However, the Treasury Department and the IRS recognize that the pre-

sumption may be over-inclusive in certain cases. Therefore, the 2001 proposed regulations provide that if the foreign person can allocate gross space or ocean income between income from sources within the United States, space, or international water, and sources without the United States, space, and international water, to the satisfaction of the Commissioner, based on all the facts and circumstances, income allocated to sources without the United States, space, and international water will be treated as foreign source income.

Several commentators stated that the presumption is overbroad, given that it applies to all space and ocean income regardless of any nexus with the foreign corporation's U.S. trade or business. Several commentators suggested that if the presumption were retained, objective standards consistent with existing rules for effectively connected income should be included to ensure that the space and ocean income has a meaningful connection with the foreign corporation's U.S. trade or business. In the absence of objective standards, commentators stated that taxpayers should be permitted to apply a reasonable allocation method on a consistent basis to all of their space and ocean income. In addition, as with §1.863-8(b)(2) of the 2001 proposed regulations, several commentators stated that under §1.863-8(b)(3) of the 2001 proposed regulations space and ocean income could in some cases be subject to multiple levels of taxation.

In response to these comments, the re-proposed regulations provide that if a foreign person, other than a CFC, is engaged in a trade or business within the United States, its space or ocean income is from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

The Treasury Department and the IRS believe that the revision in re-proposed §1.863-8(b)(2)(iii) providing that space or ocean income will be U.S. source income to the extent the space or ocean income is attributable to functions performed, resources employed, or risks assumed in the United States should mitigate commentators' concerns about potential multiple levels of taxation.

Examples 12 and 13 in §1.863-8(f) of the 2001 proposed regulations illustrate

the application of §1.863-8(b)(3) of those regulations to foreign persons that conduct certain activities in the United States. One commentator noted that these examples appear to state that engaging in certain activities would constitute the conduct of a trade or business in the United States. In response to this comment, *Examples 12 and 13* have been clarified in the re-proposed regulations to state that they assume, on the facts of the example, that the activities constitute the conduct of a trade or business within the United States within the meaning of section 864(b). The Treasury Department and the IRS intend that the determination whether a foreign person is engaged in a trade or business in the United States continue to be made under general section 864(b) principles.

5. Source rules for sales of property in space or international water

The 2001 proposed regulations provide generally that taxpayers must apply the rules of section 863(d) and the 2001 proposed regulations to determine the source of income from sales of property purchased or produced by the taxpayer, either when production occurs in whole or in part in space or international water, or when the sale occurs in space or international water. Under the 2001 proposed regulations, income from sales of inventory property (within the meaning of section 1221(a)(1)) on international water is sourced under §1.863-3(c)(2). Section 1.863-3(c)(2), as amended by the 2001 proposed regulations, provides that the place of sale will be presumed to be the United States when property is produced in the United States and the property is sold to a U.S. resident for use in space or international water; in such cases, the property will be treated as sold for use, consumption, or disposition in the United States.

Section 1.863-8(d)(1)(i) of the 2001 proposed regulations defines space activity to include the sale of property in space. Section 1.863-8(d)(1)(ii) of the 2001 proposed regulations defines ocean activity to include the sale of property in international water, but not the sale of inventory property on international water. Under §1.863-8(d)(2)(iii) of the 2001 proposed regulations, a sale occurs in space or international water if the property is located in space or international water at the time the

rights, title, and interest of the seller in the property are transferred to the purchaser, or if the property is sold for use in space or international water.

For sales in space or international water of property produced by the taxpayer, §1.863-8(b)(4)(ii)(A) of the 2001 proposed regulations generally provides that the source of income attributable to sales activity is determined under §1.863-8(b)(1), (2), or (3) of the 2001 proposed regulations. If, however, the taxpayer sells such property outside space and international water, the source of income attributable to sales activity is determined under §1.863-3(c)(2).

Commentators stated that the inclusion of sales of inventory property in space or international water in the definitions of space and ocean activity is inconsistent with the legislative history of the 1986 Act, which indicates that the Senate Committee on Finance did not intend sales of inventory property on the high seas to be considered space or ocean activity. See S. Rep. No. 99-313, at 359.

In response to comments, the re-proposed regulations provide that sales of inventory property in space or international water will be considered space or ocean activity only if the inventory property is sold for use, consumption, or disposition in space or international water. In such cases, the source of income will be determined under the source rules provided for space and ocean income by the re-proposed regulations. The source of income from sales in space or international water of inventory property when the inventory property is sold for use, consumption, or disposition outside space and international water will be determined under §§1.861-7(c) and 1.863-3(c)(2). The Treasury Department and the IRS believe that sales of property in space or international water — with the exception of sales of inventory property in space or international water for use, consumption, or disposition outside space or international water — should be considered space or ocean activity, and that the source of income from such sales should be determined under section 863(d). The Treasury Department and the IRS believe that this result is consistent with both the statute and the legislative history. The statute provides that space or ocean activity includes any activity in space or international water. However, the

Senate Report states that the Senate Committee on Finance did not intend to override the general source rule in §1.861-7(c) for sales of property on the high seas. See S. Rep. No. 99-313, at 359. Thus, sales of inventory property in transit between the United States and a foreign country will continue to be sourced under sections 861 through 865, and not section 863(d).

The repropoed regulations do not contain the presumption in §1.863-3(c)(2) of the 2001 proposed regulations regarding sales of property produced by the taxpayer in the United States to U.S. residents for use in space or international water. Under the repropoed regulations, if such sales occur in space or international water, the source of income attributable to sales activity will be determined under repropoed §1.863-8(b)(3)(ii)(D).

6. *Special rule for determining the source of income from services*

Section 1.863-8(b)(5) of the 2001 proposed regulations provides that income derived from the performance of services in space or international water is sourced under §1.863-8(b)(1), (2), or (3) of the 2001 proposed regulations, as applicable. Section 1.863-8(d)(2)(ii)(A) of the 2001 proposed regulations contains a general rule providing that the performance of a service is a space or ocean activity in its entirety when a part of the service, even if *de minimis*, is performed in space or international water.

The Treasury Department and the IRS recognized that this rule could be over-inclusive in certain cases. Therefore, §1.863-8(d)(2)(ii)(A) of the 2001 proposed regulations provides a facilitation exception, under which a service will not be treated as either space or ocean activity if the taxpayer's only activity in space or international water is to facilitate the taxpayer's own communications as part of the provision or delivery of a service provided by the taxpayer, and the service would not otherwise be a space or ocean activity. Section 1.863-8(b)(5) of the 2001 proposed regulations also provides that if the taxpayer can allocate, to the satisfaction of the Commissioner, gross income from the services transaction between performance occurring outside space and international water, and performance occurring in space or international water, the source of in-

come allocated to performance occurring outside space and international water will be determined under sections 861, 862, 863, and 865.

Several commentators commented unfavorably on a rule that characterizes an entire services transaction as space or ocean activity when only *de minimis* performance occurs in space or international water. Several commentators noted that even though §1.863-8(b)(5) of the 2001 proposed regulations permits a taxpayer to source services income to sources outside space or international water, the entire transaction continues to be characterized as space or ocean activity, and all income derived from the services transaction is thus included in the separate subpart F and foreign tax credit limitation category for shipping income. Some commentators stated that under the 2001 proposed regulations significant consequences result from characterization as a services transaction, even though the characterization rules are themselves unclear. Some commentators also stated that the facilitation exception to space or ocean activity characterization is confusing, and that the example intended to illustrate the application of the facilitation exception (*Example 4* in §1.863-8(f) of the 2001 proposed regulations) is itself unclear.

As noted above, subsequent to the publication of the 2001 proposed regulations, AJCA amended the subpart F rules relating to space and ocean income by eliminating shipping income as a category of subpart F income and reduced the number of foreign tax credit limitation categories from nine to two (with space and ocean income generally falling into the general limitation category) for taxable years beginning after December 31, 2006. The Treasury Department and the IRS believe that these statutory changes should allay commentators' concerns regarding the characterization of a services transaction as space or ocean activity. In addition, as discussed below, the repropoed regulations provide that if the taxpayer can demonstrate the value of the service attributable to performance in space or international water and the value of the service attributable to performance outside space and international water, then the service will be treated as a space or ocean activity only to the extent of the activity performed in space or international water. The value of the service is attrib-

utable to performance occurring in space or international water to the extent the performance of services, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water.

Based on the comments, the repropoed regulations eliminate the facilitation exception. Under repropoed §1.863-8(d)(2)(ii), to the extent, based on all the facts and circumstances, the value of the service attributable to functions performed, resources employed, or risks assumed in space or international water is *de minimis*, such service is not treated as space or ocean activity. The adoption of the *de minimis* rule is intended to address taxpayer concerns about potential confusion in qualifying for the facilitation exception. *Example 4* of repropoed §1.863-8(f) has been revised accordingly.

The rule for determining the source of income from performance of services that occur in part in space or international water and in part outside space and international water has been adapted to conform to the changes made to repropoed §1.863-8(d)(2)(ii). To the extent a service is characterized as space or ocean activity under repropoed §1.863-8(d)(2)(ii), the source of gross income derived from such transaction is determined under repropoed §1.863-8(b)(1) or (2), as applicable, as provided by repropoed §1.863-8(b)(4). Accordingly, to the extent the value of the service, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed outside space and international water, the service will not constitute space or ocean activity, and, to that extent, the source of income from the service will be determined under section 861, 862, or 863, as applicable.

7. *Definition of space and ocean activity*

a. *Foreign communications activity as space or ocean activity*

Section 1.863-8(b)(6) of the 2001 proposed regulations provides that space and ocean activity include communications activity (but not international communications activity) occurring in space or international water. Foreign communications activity is thus characterized under

the 2001 proposed regulations as space or ocean activity when, for example, part of the transmission is via satellite or via underwater cable located in international water.

Commentators requested that the regulations characterize income from foreign-to-foreign communications as international communications income, which is specifically excluded from the definition of space and ocean activity by section 863(d)(2)(B) and §1.863-8(d)(3) of the 2001 proposed regulations, but retain the 100 percent foreign source rule otherwise provided for foreign communications income by §1.863-9(b)(4) of the 2001 proposed regulations. International communications income is defined by section 863(e)(2) as income derived from the transmission of communications between the United States and a foreign country (or possession of the United States) and is discussed in greater detail below.

Commentators noted that this rule puts telecommunications companies using satellite or underwater cable methods of transmission at a competitive disadvantage vis-à-vis competitors in foreign marketplaces that use solely land-based facilities. For example, if a CFC were paid to transmit a telephone call between two foreign countries and used a land line connecting the two countries to transmit the call, the CFC's income from the transmission would be included in the general limitation category for foreign tax credit purposes. If the communication were transmitted using fiber optic cable located in international water or a satellite, the CFC's income from the transmission would be foreign source space or ocean income included in the separate subpart F and foreign tax credit limitation category for shipping income.

The repropoed regulations do not characterize income from foreign-to-foreign communications as international communications income as suggested by commentators. Section 863(d)(2)(A) broadly defines space and ocean activity as *any activity* conducted in space or international water. The statutory exception to space and ocean activity in section 863(d)(2)(B) removes only activities giving rise to international communications income from the scope of space and ocean activity. In addition, if foreign-to-foreign communications income

were characterized as international communications income, U.S. persons with such income would be subject to the statutory source rule in section 863(e)(1)(A), which provides for the split-sourcing of a U.S. person's international communications income. The Treasury Department and the IRS thus consider the language of the statute to preclude the approach suggested by commentators with respect to the characterization and sourcing of income from foreign-to-foreign communications. The legislative history of the 1986 Act also indicates that Congress intended income from foreign-to-foreign communications to be foreign source income. See S. Rep. No. 99-313, at 359, "Finally, if the communication is between two foreign locations, the committee intends income attributable thereto to be foreign source." This would not be the result, however, if foreign-to-foreign communications income were included in the definition of international communications income and thus subject to the statute's 50/50 source rule for U.S. persons.

In addition, as noted above, AJCA made significant changes to subpart F and the foreign tax credit regime as applicable to space and ocean income. The Treasury Department and the IRS believe that these statutory changes should allay commentators' concerns regarding the characterization of foreign-to-foreign communications as space or ocean activity.

The Treasury Department and the IRS believe that the modifications in the repropoed regulations with respect to the characterization of services involving space or ocean activities address some of the commentators' concerns regarding the characterization of foreign-to-foreign communications activities involving services performed both in space or international water and in foreign countries. Repropoed §1.863-8(d)(2)(ii) provides that a transaction characterized as the performance of a service will be treated as a space or ocean activity only to the extent the value of the service, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water.

b. *Definition of space*

Section 1.863-8(d)(1)(i) of the 2001 proposed regulations defines space as any

area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, and not in international water. Under the 2001 proposed regulations, space comprises the entire area outside the jurisdiction of any country or U.S. possession, extending from just above the surface of international water (and Antarctica) through, and beyond, the earth's atmosphere. Space thus includes international airspace.

Several commentators stated that the definition of space should be limited to the area beyond the earth's atmosphere. One commentator proposed a definition of space that conforms to a definition used for non-tax purposes (for example, beyond the maximum altitude at which powered flight by aircraft equipped with air-breathing engines is possible). Another commentator stated that the definition of space could be read to include cyberspace, the electronic medium in which online communication takes place, and suggested that cyberspace be specifically excluded from the definition of space. One commentator noted language in the legislative history stating that space activities had not been very prevalent at the time of the 1986 Act (see, for example, S. Rep. No. 99-313, at 358) and argued that Congress did not intend to include international airspace in space.

No changes were made to the repropoed regulations in response to these comments. The Treasury Department and the IRS believe a broad definition of space that includes international airspace is consistent with legislative intent to assert primary tax jurisdiction over income earned by U.S. residents that is not within any foreign country's taxing jurisdiction. See, e.g., S. Rep. No. 99-313, at 357. The Treasury Department and the IRS also believe that providing guidance with respect to the place of performance of activities involving online communications is beyond the scope of the present regulations, and that taxpayers should rely on generally applicable principles to determine where functions are performed, resources are employed, or risks are assumed in a specific online transaction.

c. *Transportation income*

Certain activities occurring in space or international water are not considered

either space or ocean activity. Section 1.863-8(d)(3)(i) of the 2001 proposed regulations, consistent with section 863(d), provides that space or ocean activity does not include any activity that gives rise to transportation income as defined in section 863(c).

One commentator stated that a portion of a bareboat charter — the return of an empty vessel that has unloaded its cargo (backhaul) — may potentially be considered ocean activity under the 2001 proposed regulations. Another commentator stated that income from container leasing by a party other than the ship operator could constitute space or ocean income, and could be subject to withholding tax. One commentator also suggested that the regulations should state that they do not apply to the income of foreign corporations derived from the international operation of ships, or to container leasing.

The repropoed regulations do not adopt changes to reflect these comments. The repropoed regulations reflect the broad statutory definition of ocean activity in section 863(d)(2) as “any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States.” The Treasury Department and the IRS do not consider it appropriate to construe the definition of section 863(c) transportation income in the context of these regulations. The Treasury Department and the IRS will consider addressing the definition of section 863(c) transportation income in separate guidance.

8. *Treatment of partnerships*

Section 1.863-8(e) of the 2001 proposed regulations generally provides that section 863(d) and the regulations thereunder will be applied to domestic partnerships at the partnership level and to foreign partnerships at the partner level. Commentators suggested that the source rules of §1.863-8 of the 2001 proposed regulations be applied to all partnerships either at the entity level or at the partner level.

The Treasury Department and the IRS believe that section 863(d) should be applied to domestic and foreign partnerships in the same manner. Accordingly, the repropoed regulations do not provide a dif-

ferent rule for foreign partnerships and domestic partnerships. Section 1.863-8(e) of the repropoed regulations provides that section 863(d) and the regulations thereunder will be applied to domestic partnerships at the partner level. In order to conform the treatment of domestic and foreign partnerships, no change was made with respect to the rule in the 2001 proposed regulations that section 863(d) and the regulations thereunder will be applied to foreign partnerships at the partner level.

9. *Allocations*

When a taxpayer must allocate gross income to the satisfaction of the Commissioner, based on all the facts and circumstances, under the provisions of the 2001 proposed regulations, the Treasury Department and the IRS believe such allocations generally should be based on section 482 principles.

Several commentators stated that allocation of gross income based on section 482 principles will be burdensome and expensive and will create uncertainty. Commentators also noted that the 2001 proposed regulations provide no guidance on allocating income other than a facts and circumstances approach.

The Treasury Department and the IRS consider the allocation of gross income based on the general guidance of section 482 to be an approach that is well-suited to application in the wide variety of factual contexts within the scope of the repropoed regulations. The Treasury Department and the IRS solicit comments on alternative methods of allocation for particular industries and criteria that could be used to evaluate the reasonableness of such methods.

10. *Reporting and documentation requirements*

In order to satisfy the Commissioner with respect to a taxpayer’s allocation of gross income under §1.863-8(b)(3), (b)(4)(ii)(C), or (b)(5) of the 2001 proposed regulations, the taxpayer must make the allocation on a timely filed original return (including extensions). An amended return does not qualify for this purpose, and section 9100 relief will not be available. In all cases, a taxpayer must also maintain contemporaneous documentation regarding the allocation of gross income,

allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must produce such documentation within 30 days upon request.

Commentators stated that neither the statute nor the legislative history provides a basis for the reporting, recordkeeping, and contemporaneous documentation requirements in the 2001 proposed regulations. Commentators also noted that the Code and regulations do not contain similar requirements with respect to certain other expense allocation provisions.

The repropoed regulations generally retain the recordkeeping and documentation requirements. The Treasury Department and the IRS believe that it is appropriate to require taxpayers to keep proper records, and additionally note the potentially considerable difficulties the IRS would face in performing the allocations required by the repropoed regulations without appropriate taxpayer records.

The Treasury Department and the IRS recognize, however, that taxpayers may not have all the information necessary to make allocations at the time a return is originally filed. The repropoed regulations therefore provide that a taxpayer may make changes to allocations made on the taxpayer’s original return with respect to any taxable year for which the statute of limitations has not closed, subject to certain conditions. Nonetheless, changes to such allocations that are not made until an audit of the taxable year to which the allocations relate has commenced, or a taxpayer’s failure timely to provide documentation and other information supporting the allocations, create administrative difficulties for the IRS. Accordingly, repropoed §1.863-8(g)(4) sets forth the actions required of taxpayers and the procedures the IRS will follow in the case of taxpayers that change their allocations.

The repropoed regulations also require taxpayers, upon request, to provide access to the software programs and other systems used by the taxpayer to make allocations under these regulations. For this purpose, software has the meaning provided in section 7612(d). The Treasury Department and the IRS believe that the IRS could face significant administrative and other difficulties in the examination of allocations

made under these regulations without access to such software.

11. Examples

Certain examples in §1.863-8(f) of the 2001 proposed regulations contain statements regarding the characterization of certain activities (as, for example, the lease of equipment or the performance of services). One commentator suggested that the examples clarify that the character of the transactions at issue is only assumed for purposes of the specific example. In response to this comment, the examples in repropoed §1.863-8(f) have been revised to make clear that the characterization of certain transactions is assumed based on the facts of the specific example. The Treasury Department and the IRS did not consider it necessary to modify certain other examples (for example, *Example 1* of repropoed §1.863-8(f)) in which the character of the transaction at issue should be clear under the facts presented.

In addition, *Examples 2, 3, 4, and 7* of repropoed §1.863-8(f), have been revised to reflect substantive changes made to repropoed §1.863-8(b)(4) and (d)(2)(ii) with respect to services that involve activities performed in space or international water.

B. Communications Activity under Section 863(a), (d), and (e)

1. International communications income

International communications income is defined by section 863(e)(2) as income derived from the transmission of communications between the United States and a foreign country (or possession of the United States). Section 863(e)(1)(A) provides that in the case of any U.S. person, 50 percent of any international communications income will be sourced in the United States and 50 percent of such income will be sourced outside the United States. Section 863(e)(1)(B)(i) provides that any international communications income of a foreign person will be foreign source income except as provided in regulations or in section 863(e)(1)(B)(ii). Section 1.863-9(b)(2)(ii)(A) of the 2001 proposed regulations states the general rule that international communications income of a foreign person is foreign source income. However, the 2001 proposed reg-

ulations contain certain exceptions to the general rule.

2. International communications income of 50-percent or more U.S.-owned foreign corporations

The first exception, in §1.863-9(b)(2)(ii)(B) of the 2001 proposed regulations, provides that if U.S. persons own 50 percent or more of a foreign corporation by vote or value (directly, indirectly, or constructively), including a CFC within the meaning of section 957, international communications income derived by that corporation is entirely U.S. source income.

As with the similar rule provided for the space and ocean income of U.S.-owned foreign corporations in §1.863-8(b)(2) of the 2001 proposed regulations, several commentators requested that the rule be withdrawn because it expands the scope of U.S. taxing jurisdiction beyond the apparent intent of Congress. Commentators stated that the rule is punitive in nature because it is less favorable than the 50/50 source rule applied to international communications income earned directly by U.S. persons. As with §1.863-8(b)(2) and (3) of the 2001 proposed regulations, commentators also stated that under the rule the international communications income of certain foreign corporations may be subject to multiple levels of taxation.

Commentators noted that in certain circumstances international communications income could be subject to the 30-percent gross income tax imposed by section 881, which is typically collected through withholding by the payors of such income. Commentators stated that although most tax treaties should prevent the imposition of the 30-percent tax (international communications income would likely be characterized as business profits under most treaties and would accordingly be exempt from U.S. taxation unless attributable to a permanent establishment in the United States), the rule in the 2001 proposed regulations would result in disparate treatment for corporations from treaty countries vis-à-vis corporations from non-treaty countries. The requirement to withhold the 30-percent tax could also create numerous administrative and enforcement difficulties. In addition, given the extent of resale of capacity between telecom-

munications providers, commentators noted that payments relating to the same transmission could be subject to multiple withholding. Finally, as with the similar rule provided for the space and ocean income of U.S.-owned foreign corporations in §1.863-8(b)(2) of the 2001 proposed regulations, commentators raised the issue of potential difficulties in determining whether a foreign corporation is 50-percent or more U.S.-owned.

As noted above, several commentators addressed the stock ownership test applicable to U.S.-owned foreign corporations. They stated that determining whether a foreign corporation is 50-percent U.S. owned, especially without regard to the size of an owner's holding, presents potential difficulties (for example, when the foreign corporation is widely-held).

In light of the potential complexity in determining whether a foreign corporation is a U.S.-owned foreign corporation and the belief of the Treasury Department and the IRS that international communications income earned by foreign corporations should be sourced in accord with the rules for foreign persons, with the limited exception for CFCs discussed below, the repropoed regulations do not include a special source rule for international communications income earned by a 50 percent or more U.S.-owned foreign corporation. Instead, the international communications income of foreign corporations (other than CFCs) is sourced under the applicable provisions of repropoed §1.863-9(b)(2)(i), (iii), and (iv).

3. International communications income of CFCs

In light of the comments with respect to CFCs described above, the repropoed regulations provide that in the case of a CFC, 50 percent of any international communications income will be sourced in the United States and 50 percent of such income will be sourced outside the United States. The 100-percent U.S. source rule is eliminated. Consequently, the source rule for international communications income in the hands of a CFC is the same rule that applies to U.S. persons. In both cases, the source rules take into account that international communications activities must have both a U.S. and a foreign connection (*i.e.*, one endpoint in the United States and

the other in a foreign country or possession of the United States). The Treasury Department and the IRS believe that the revision of the source rule for CFCs deriving international communications income should mitigate commentators' concerns about potential multiple levels of taxation because 50 percent of this income is foreign source.

The Treasury Department and the IRS recognize that this and other provisions of repropoed §1.863-9 may raise withholding tax issues similar to those discussed above in connection with the source rule for the space and ocean income of CFCs (in repropoed §1.863-8(b)(2)(ii)). As noted above, the Treasury Department and the IRS seek comments on these issues and practical suggestions to address them in the specific factual contexts in which they may arise.

4. *International communications income derived by a foreign person with an office or fixed place of business in the United States*

Section 863(e)(1)(B)(ii) and §1.863-9(b)(2)(ii)(C) of the 2001 proposed regulations provide that international communications income derived by a foreign person that is attributable to an office or other fixed place of business in the United States is from sources within the United States. Section 864 and the regulations thereunder provide guidance in determining "income ... attributable to an office or other fixed place of business" in specific contexts. However, the Treasury Department and the IRS believe that, for purposes of section 863(e), international communications income should be attributed to an office or fixed place of business based on functions performed, resources employed, and risks assumed. Therefore, pursuant to the regulatory authority in section 863(e)(1)(B)(i), the repropoed regulations provide that, for purposes of this section, income is attributable to an office or other fixed place of business in the United States to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business.

5. *International communications income of a foreign person engaged in a trade or business within the United States*

The second exception to §1.863-9(b)(2)(ii)(A) of the 2001 proposed regulations is contained in §1.863-9(b)(2)(ii)(D), which provides that if a foreign person (other than a 50 percent or more U.S.-owned foreign corporation described in §1.863-9(b)(2)(ii)(B) of the 2001 proposed regulations) is engaged in a trade or business within the United States, the foreign person's international communications income is presumed to be U.S. source income. However, if the foreign person can allocate its international communications income between sources within the United States, space, and international water and sources outside the United States, space, and international water to the satisfaction of the Commissioner, based on all the facts and circumstances, which may include functions performed, resources employed, or risks assumed, then the income allocated to sources outside the United States, space, and international water will be foreign source income.

Several commentators stated that the presumption is overbroad because it applies to all international communications income regardless of any nexus with the foreign corporation's U.S. trade or business. These commentators claimed that the presumption is inconsistent with U.S. tax policy and international norms that require a connection between the income and the foreign person's activities in the United States before U.S. taxing jurisdiction is exercised.

In response to comments, the repropoed regulations provide that if a foreign person, other than a CFC, is engaged in a trade or business within the United States, gross income derived by that person from international communications activity is from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States. This rule is similar to the rule in the repropoed regulations under section 863(d) for foreign persons engaged in a trade or business within the United States. There is no longer a presumption of U.S. source income.

The Treasury Department and the IRS believe that the provision in the repropoed regulations that such a foreign person's international communications income is U.S. source only to the extent attributable to functions performed, resources employed, or risks assumed in the United States addresses taxpayers' concerns regarding a nexus between the foreign person's international communications income and its business activities in the United States.

Several commentators objected to the rule that international communications income could be foreign source income only to the extent that the foreign person could allocate international communications income to activity occurring in a foreign country. Because the repropoed regulations provide for U.S. sourcing only to the extent that the foreign person's international communications income is attributable to functions performed, resources employed, or risks assumed in the United States, this concern should be mitigated.

Several commentators stated that section 863(e) makes international communications income that is attributable to a U.S. office U.S. source income, and that the regulations should not adopt a broader U.S. trade or business rule. Section 863(e)(1)(B)(ii) provides that if a foreign person has a fixed place of business in the United States, international communications income attributable to such fixed place of business is U.S. source income. The Treasury Department and the IRS have not made changes to the repropoed regulations in response to these comments. Section 863(e)(1)(B)(i) by its terms gives the Secretary broad authority to source international communications income of a foreign person as U.S. source income. The Treasury Department and the IRS believe that it is appropriate to exercise that authority in this case. The trade or business rule reflects the concern of the Treasury Department and the IRS that a foreign person could avoid a U.S. fixed place of business under section 863(e)(1)(B)(ii), yet engage in significant communications activity in the United States. The Treasury Department and the IRS believe that Congress intended that a foreign person engaged in substantial business in the United States be subject to U.S. tax on that communications activity.

6. *Income derived from communications activity — the paid-to-do rule*

Income derived from communications activity is defined in §1.863-9(d)(2) of the 2001 proposed regulations as income derived from the transmission of communications, including income derived from the provision of capacity to transmit communications. There is no requirement that the recipient of communications income perform the transmission function itself. This rule reflects the understanding of the Treasury Department and the IRS that providers of communications services often use capacity owned or operated by others. However, income is derived from communications activity only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications.

Section 1.863-9(d)(3) of the 2001 proposed regulations provides rules for characterizing income derived from a communications activity for purposes of sourcing the income derived from such activity. The character of income derived from communications activity is determined by establishing the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication (the paid-to-do rule). Under the paid-to-do rule, the path the communication takes between the two points is not relevant in determining the character of the transmission. If a taxpayer is paid to take a communication from one point to another point, income derived from the transmission is characterized based on the transmission between those two points, even if the taxpayer contracts out part of the transmission to another party. This rule reflects the recognition by the Treasury Department and the IRS, as noted above, that providers of communications services often use capacity owned or operated by others.

When the taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication, §1.863-9(b)(6) of the 2001 proposed regulations provides a default source rule, under which all income from the communications activity, whether derived by a U.S. person or a foreign person, is deemed to be from sources within the United States. Thus, for example, when a provider of communications services provides both local and international long distance services in one-price bundles for

a set amount each month and tracing each transmission is not possible or practical, the income derived from the communications activity is U.S. source income. The Treasury Department and the IRS understand that many taxpayers in the communications industry may consider it impractical or impossible to prove the endpoints of the communications they transmit. The Treasury Department and the IRS accordingly solicited comments as to proposals for those situations when taxpayers cannot establish the points between which the taxpayer is paid to transmit the communication.

One commentator stated that the phrase “bears the risk of transmitting,” contained in §1.863-9(d)(2) and (d)(3)(i) of the 2001 proposed regulations, is ambiguous and does not meaningfully improve the determination of when income is derived from communications activity. This commentator noted that the nature of the risk a taxpayer must bear to be treated as deriving communications income was unclear, and that the determination of risk would pose administrative difficulties given the complexity of business models and structures. No change was made to the re-proposed regulations in response to this comment. The Treasury Department and the IRS believe that, in determining whether a taxpayer derives communications income, risk is more important than the mere fact of payment. The Treasury Department and the IRS thus believe that a taxpayer should not be considered to derive communications income unless the taxpayer bears the economic risk of nonpayment with respect to the transmission of communications or the provision of capacity to transmit communications.

Commentators stated that the paid-to-do rule is overbroad because it asserts primary U.S. taxing jurisdiction over certain communications income regardless of any nexus between the income and the United States. Commentators also noted that when certain taxpayers cannot establish the two points between which they are paid to transmit a communication, the income from such communications activity may be subject to potential double taxation at the corporate level (for example, a foreign corporation could be subject to tax on such communications income in both the United States and in the foreign corporation’s country of residence

or incorporation or countries where it does business).

Commentators stated that the paid-to-do rule places undue burdens on taxpayers who want to obtain the benefit of foreign source income characterization. Commentators noted that, in many cases, it may be impractical or technologically impossible to track the origination and termination points of an individual transmission, and that development of the required technology, software, and other systems would require significant capital investments. Maintenance of the records needed to substantiate proper income sourcing could also be onerous for those taxpayers who perform extremely large numbers of transmissions. Commentators thus requested that the regulations provide assurance that reasonable methods of proof, consistent with industry practice and consistently applied, would be accepted in establishing the points of origin and/or destination of a communication.

Commentators submitted suggested modifications to the paid-to-do rule. One commentator suggested that the paid-to-do rule be modified to characterize all income from a communication based on the two endpoints between which the transmission is made. Under this commentator’s suggested rule, whether a particular taxpayer itself carried out all, or only a portion, of the transmission would be irrelevant, and the characterization of the communication would be the same for all taxpayers involved in the transmission. One commentator suggested that the paid-to-do rule be applied on a single entity basis for United States corporations that join in the filing of a consolidated U.S. income tax return.

Commentators also suggested reasonable method approaches to determine the endpoints between which a taxpayer is paid to transmit communications (for example, based on technical characteristics of the communication or contractual terms, or on a per transaction, per customer, or aggregate basis). One commentator suggested factors that could be taken into account in determining whether a particular method is reasonable, including the reliability of the method chosen, the degree to which the method is in line with generally accepted industry practices and norms, and the extent to which the method

takes into account all the information available to the taxpayer.

Commentators suggested that the U.S. source default rule for income from communications for which the endpoints of transmission cannot be identified should only apply to foreign taxpayers that directly own or operate communications facilities, or otherwise directly hold rights to communications capacity, in the United States; when a foreign taxpayer does not own or otherwise have rights to telecommunications capacity in the United States, income from such communications would thus be foreign source. Other commentators suggested that income from communications for which the endpoints of transmission cannot be identified be treated in the same manner as international communications income, with a 100-percent U.S. source exception provided for telecommunications service providers who are paid to transmit communications that are substantially all between multiple points located within the United States.

The Treasury Department and the IRS continue to believe that communications activity is most appropriately characterized based on the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication. The Treasury Department and the IRS consider the endpoint-based source rule in the repropounded regulations to be an approach that best matches the source of communications income to the location where functions are performed, resources are employed, or risks are assumed in a taxpayer's communications transaction. Moreover, although commentators noted potential difficulties in identifying the endpoints of a communication, the industry-specific comments received in response to the 2001 proposed regulations generally focused on record-keeping burdens. Taxpayers have much better access to the relevant information regarding the facts and circumstances of their communications transactions than the IRS. The Treasury Department and the IRS accordingly solicit comments on the challenges to identifying the endpoints of communications in specific industries or situations, as well as suggestions for rules that are responsive to these particular challenges. The Treasury Department and the IRS also again solicit comments on methods to identify the endpoints of

a communication that may be reasonable for particular industries, as well as criteria that may be appropriate to evaluate the reasonableness of such methods.

7. *Treatment of a content provider's communications activity*

Section 1.863-9(d)(1)(ii) of the 2001 proposed regulations provides that, to the extent a taxpayer's transaction consists in part of non-*de minimis* communications activities and in part of non-*de minimis* non-communications activities, such parts of the transaction must be treated as separate transactions. Section 1.863-9(d)(1)(ii) of the 2001 proposed regulations then provides that gross income derived from the activities must be allocated to each separate transaction, to the satisfaction of the Commissioner, based on all the facts and circumstances, which may include functions performed, resources employed, or risks assumed in the respective transactions.

One commentator suggested that the regulations be clarified to provide that a *content* company (for example, the creator of a television or radio program) that does not possess or operate communications equipment or itself perform any communications function is not engaged in communications activities. This commentator did not believe that communication activities should be attributed to a content provider and stated that delivery of a content provider's programming by a third party should not change the character of the content provider's income to communications income.

No changes were made to the repropounded regulations in response to this comment. The Treasury Department and the IRS believe that the transmission of any communications, including content, is appropriately considered a communications activity. The Treasury Department and the IRS also believe that when a content provider is paid to transmit, and bears the risk of transmitting, content to a customer, the content provider should be considered to derive communications income. Under repropounded §1.863-9(h)(1)(ii), as under the 2001 proposed regulations, the content provider will derive communications income only to the extent of the gross income allocated to the separate transaction involving the communications activity.

The Treasury Department and the IRS believe that it is appropriate for a content provider to derive communications income when communications activities make more than a *de minimis* contribution to the value of the content provider's overall transaction with its customer.

8. *Treatment of partnerships*

Section 1.863-9(e)(1) of the 2001 proposed regulations generally provides that section 863(e) and the regulations thereunder will be applied to domestic partnerships at the partnership level. Section 1.863-9(e)(1) of the 2001 proposed regulations also provides that section 863(e) and the regulations thereunder will be applied at the partner level to foreign partnerships. Section 1.863-9(e)(2) of the 2001 proposed regulations similarly provides that section 863(e) and the regulations thereunder will be applied at the partner level to domestic partnerships in which 50 percent or more of the partnership interests are owned by foreign persons.

One commentator stated that §1.863-9(e)(2) of the 2001 proposed regulations conflicts with sections 863(e)(1)(A) (which provides that the international communications income of any United States person shall be 50-percent U.S. source and 50-percent foreign source) and 7701(a)(3) (which defines United States person to include a domestic partnership). According to this commentator, the rule potentially discriminates against foreign partners in a domestic partnership owned 50 percent or more by foreign partners vis-à-vis the U.S. partners in such a partnership. For example, the international communications income of a foreign partner could be 100-percent U.S. source under §1.863-9(b)(2)(ii)(B) or (C) of the 2001 proposed regulations, whereas the international communications income of a U.S. partner would be 50-percent U.S. source and 50-percent foreign source, creating the potential for double taxation of the foreign partner. Another commentator stated that §1.863-9(e)(1) of the 2001 proposed regulations could result in the double taxation of the U.S. partners of foreign partnerships. This commentator noted that the international communications income of a foreign partnership could be subject to tax in the country in

which the foreign partnership is organized. Under §1.863-9(e) of the 2001 proposed regulations, a U.S. partner's share of such international communications income would be subject to the 50/50 source rule in §1.863-9(b)(2)(i) of the 2001 proposed regulations. As a result, the U.S. partner may be unable to credit its proportionate share of tax paid in the foreign country. Commentators suggested that the source rules of §1.863-9 of the 2001 proposed regulations be applied to all partnerships at the entity level.

As is the case for repropoed §1.863-8(e) with respect to section 863(d), the Treasury Department and the IRS believe that section 863(e) should be applied to domestic and foreign partnerships in the same manner. Accordingly, the repropoed regulations do not provide a different rule for foreign partnerships and domestic partnerships. Section 1.863-9(i) of the repropoed regulations provides that the regulations will be applied at the partner level for all partnerships.

9. Allocations

When a taxpayer must allocate gross income to the satisfaction of the Commissioner, based on all the facts and circumstances, under §1.863-9(b)(2)(ii)(D) or (d)(1)(ii) of the 2001 proposed regulations, the Treasury Department and the IRS believe that such allocations should be based generally on section 482 principles. As with §1.863-8 of the 2001 proposed regulations, commentators stated that allocation of income based on section 482 principles would be burdensome and expensive and would create uncertainty.

The Treasury Department and the IRS consider the allocation of gross income based on the general guidance of section 482 to be an approach that is well-suited to application in the wide variety of factual contexts within the scope of the repropoed regulations. The Treasury Department and the IRS solicit comments on alternative methods of allocation for particular industries and criteria that could be used to evaluate the reasonableness of such methods.

10. Issues with uplink functions

Examples 5, 10, and 12 of §1.863-9(f) of the 2001 proposed regulations involve communications activities that include the

performance of satellite uplink and downlink functions. One commentator stated that these examples do not provide clear guidance as to whether the satellite operator must itself perform the uplink function in order for its income to qualify as international communications income, and could be read to treat a satellite operator that contracts with another party to transmit signals as not engaged in international communications activity because the uplink function is performed by that other party.

No changes were made to the repropoed regulations in response to this comment. Repropoed §1.863-9(h)(2) provides that income may be considered derived from a communications activity even if the taxpayer does not perform the transmission function, but, in all cases, a taxpayer derives communications income only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications. The Treasury Department and the IRS believe that whether a satellite operator should be considered to derive international telecommunications income from a transaction is appropriately determined by applying repropoed §1.863-9(h)(2), as well as the other substantive provisions of the repropoed regulations, to the specific facts of the taxpayer's transaction.

11. Characterization of income

One commentator stated that the regulations should be clarified to provide that they do not purport to establish general rules for the characterization of income and that the characterization of income items for purposes of the application of section 863(d) and (e) is to be made under general principles of tax law. This commentator stated that some examples in the 2001 proposed regulations could suggest conflicting characterizations of income from what appear to be the same activities. In response to this comment, the examples in the repropoed regulations have been clarified to state that the characterization of the transactions at issue is assumed for purposes of the specific example. In addition, certain examples have been reconciled to the extent they could suggest different characterizations of the same activities.

12. Reporting and documentation requirements

In order to satisfy the Commissioner with respect to a taxpayer's allocation of gross income under §1.863-9(b)(2)(ii)(D) or (d)(1)(ii) of the 2001 proposed regulations, the taxpayer must make the allocation on a timely filed original return (including extensions). An amended return does not qualify for this purpose, and section 9100 relief will not be available. In all cases, a taxpayer must also maintain contemporaneous documentation regarding the allocation of gross income, allocation and apportionment of expenses, losses and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must produce such documentation within 30 days upon request.

As with the similar requirements under §1.863-8 of the 2001 proposed regulations, commentators stated that there is no basis in the statute or the legislative history for the reporting, recordkeeping, and contemporaneous documentation requirements in the 2001 proposed regulations. Commentators also noted that the Code and regulations do not contain similar requirements with respect to other expense allocation provisions.

The repropoed regulations generally retain the recordkeeping and documentation requirements. The Treasury Department and the IRS believe that it is appropriate to require taxpayers to keep proper records, and additionally note the potentially considerable difficulties the IRS would face in performing the allocations required by the repropoed regulations without appropriate taxpayer records.

The Treasury Department and the IRS recognize, however, that taxpayers may not have all the information necessary to make allocations at the time a return is originally filed. The repropoed regulations therefore provide that a taxpayer may make changes to allocations made on the taxpayer's original return with respect to any taxable year for which the statute of limitations has not closed, subject to certain conditions. Nonetheless, changes to such allocations that are not made until an audit of the taxable year to which the allocations relate has commenced, or a taxpayer's failure timely to provide documentation and other information supporting the

allocations, create administrative difficulties for the IRS. Accordingly, repropoed §1.863-9(k)(4) sets forth the actions required of taxpayers and the procedures the IRS will follow in the case of taxpayers changing their allocations.

The repropoed regulations also require taxpayers, upon request, to provide access to the software programs and other systems used by the taxpayer to make allocations under these regulations. For this purpose, *software* has the meaning provided in section 7612(d). The Treasury Department and the IRS believe that the IRS could face significant administrative and other difficulties in the examination of income allocations made under these regulations without access to such software.

Proposed Effective Date

These regulations are proposed to apply for taxable years beginning on or after the date of publication of final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment pursuant to that Order 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. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules provided in these regulations principally affect large multinational corporations that pay foreign taxes on income derived from substantial foreign operations and that use these and any other applicable source rules in determining their foreign tax credit. Accordingly, a Regulatory Flexibility Act assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 15, 2005, at 10 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information on having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by November 23, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Edward R. Barret of the Office of the Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Withdrawal of Previous Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-106030-98) that was published in the **Federal Register** on January 17, 2001 (66 FR 3903), is withdrawn as of September 19, 2005.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.863-8 also issued under 26 U.S.C. 863(a), (b) and (d). * * *

Section 1.863-9 also issued under 26 U.S.C. 863(a), (d) and (e). * * *

Par. 2. Section 1.863-3 is amended by:

1. Adding a sentence after the first sentence in paragraph (a)(1).
2. Adding a sentence at the end of paragraph (c)(1)(i)(A).
3. Adding a sentence after the first sentence in paragraph (c)(2).

The additions read as follows:

§1.863-3 Allocation and apportionment of income from certain sales of inventory.

(a) * * * (1) * * * To determine the source of income from sales of property produced by the taxpayer, when the property is either produced in whole or in part in space or on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (in international water), or is sold in space or international water, the rules of §1.863-8 apply, and the rules of this section do not apply except to the extent provided in §1.863-8. * * *

* * * * *

(c) * * * (1) * * * (i) * * * (A) * * * For rules regarding the source of income when production takes place, in whole or in part, in space or international water, the rules of §1.863-8 apply, and the rules of this section do not apply except to the extent provided in §1.863-8.

* * * * *

(2) * * * Notwithstanding any other provision, for rules regarding the source of income when a sale takes place in space or international water, the rules of §1.863-8 apply, and the rules of this section do not apply except to the extent provided in §1.863-8. * * *

* * * * *

Par. 3. Sections 1.863-8 and 1.863-9 are added to read as follows:

§1.863-8 Source of income from space and ocean activity under section 863(d).

(a) *In general.* Income of a United States or a foreign person derived from space and ocean activity (space and ocean income) is sourced under the rules of this section, notwithstanding any other provision, including sections 861, 862, 863, and 865. A taxpayer will not be considered to derive income from space or ocean activity, as defined in paragraph (d) of this section, if such activity is performed by another person, subject to the rules for the treatment of consolidated groups in §1.1502-13.

(b) *Source of gross income from space and ocean activity—(1) Space and ocean income derived by a U.S. person.* Space and ocean income derived by a U.S. person is income from sources within the United States. However, space and ocean income derived by a U.S. person is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(2) *Space and ocean income derived by a foreign person—(i) In general.* Space and ocean income derived by a person other than a U.S. person is income from sources without the United States, except as otherwise provided in this paragraph (b)(2).

(ii) *Space and ocean income derived by a controlled foreign corporation.* Space and ocean income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is income from sources within the United States. However, space and ocean income derived by a CFC is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources em-

ployed, or risks assumed in a foreign country or countries.

(iii) *Space and ocean income derived by foreign persons engaged in a trade or business within the United States.* Space and ocean income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(3) *Source rules for income from certain sales of property—(i) Sales of purchased property.* When a taxpayer sells purchased property in space or international water, the source of gross income from the sale generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) (inventory property) and is not sold for use, consumption, or disposition in space or international water, the source of income from the sale will be determined under §1.861-7(c).

(ii) *Sales of property produced by the taxpayer—(A) General.* If the taxpayer both produces property and sells such property, the taxpayer must allocate gross income from such sales between production activity and sales activity under the 50/50 method. Under the 50/50 method, one-half of the taxpayer's gross income will be considered income allocable to production activity, and the source of that income will be determined under paragraph (b)(3)(ii)(B) or (C) of this section. The remaining one-half of such gross income will be considered income allocable to sales activity, and the source of that income will be determined under paragraph (b)(3)(ii)(D) of this section.

(B) *Production only in space or international water; or only outside space and international water.* When production occurs only in space or international water, income allocable to production activity is sourced under paragraph (b)(1) or (2) of this section, as applicable. When production occurs only outside space and international water, income allocable to production activity is sourced under §1.863-3(c)(1).

(C) *Production both in space or international water and outside space and in-*

ternational water. When property is produced both in space or international water and outside space and international water, gross income allocable to production activity must be allocated to production occurring in space or international water and production occurring outside space and international water. Such gross income is allocated to production activity occurring in space or international water to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water. The balance of such gross income is allocated to production activity occurring outside space and international water. The source of gross income allocable to production activity in space or international water is determined under paragraph (b)(1) or (2) of this section, as applicable. The source of gross income allocated to production activity occurring outside space and international water is determined under §1.863-3(c)(1).

(D) *Source of income allocable to sales activity.* When property produced by the taxpayer is sold outside space and international water, the source of gross income allocable to sales activity will be determined under §§1.861-7(c) and 1.863-3(c)(2). When property produced by the taxpayer is sold in space or international water, the source of gross income allocable to sales activity generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1) and is sold in space or international water for use, consumption, or disposition outside space, international water, or the United States, the source of gross income allocable to sales activity will be determined under §§1.861-7(c) and 1.863-3(c)(2).

(4) *Special rule for determining the source of gross income from services.* To the extent a transaction characterized as the performance of a service constitutes a space or ocean activity, as determined under paragraph (d)(2)(ii) of this section, the source of gross income derived from such transaction is determined under paragraph (b)(1) or (2) of this section.

(5) *Special rule for determining source of income from communications activity (other than income from international communications activity).* Space and

ocean activity, as defined in paragraph (d) of this section, includes activity that occurs in space or international water that is characterized as a communications activity as defined in §1.863–9(h)(1) (other than international communications activity). The source of space and ocean income that is also communications income as defined in §1.863–9(h)(2) (but not space/ocean communications income as defined in §1.863–9(h)(3)(v)) is determined under the rules of §1.863–9(c), (d), and (f), as applicable, rather than under paragraph (b) of this section. The source of space and ocean income that is also space/ocean communications income as defined in §1.863–9(h)(3)(v) is determined under the rules of paragraph (b) of this section. See §1.863–9(e).

(c) *Taxable income.* When a taxpayer allocates gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section, the taxpayer must allocate expenses, losses, and other deductions as prescribed in §§1.861–8 through 1.861–14T to the class or classes of gross income that include the income so allocated in each case. A taxpayer must then apply the rules of §§1.861–8 through 1.861–14T to apportion properly amounts of expenses, losses, and other deductions so allocated to such gross income between gross income from sources within the United States and gross income from sources without the United States.

(d) *Space and ocean activity*—(1) *Definition*—(i) *Space activity.* In general, space activity is any activity conducted in space. For purposes of this section, space means any area not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States, and not in international water. For purposes of determining space activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as part of a single transaction. Paragraph (d)(3) of this section lists specific exceptions to the general definition of space activity. Activities that constitute space activity include but are not limited to—

(A) Performance and provision of services in space, as defined in paragraph (d)(2)(ii) of this section;

(B) Leasing of equipment located in space, including spacecraft (for example, satellites) or transponders located in space;

(C) Licensing of technology or other intangibles for use in space;

(D) Production, processing, or creation of property in space, as defined in paragraph (d)(2)(i) of this section;

(E) Activity occurring in space that is characterized as communications activity (other than international communications activity) under §1.863–9(h)(1);

(F) Underwriting income from the insurance of risks on activities that produce space income; and

(G) Sales of property in space (see §1.861–7(c)), but not sales of inventory property for use, consumption, or disposition outside space or international water.

(ii) *Ocean activity.* In general, ocean activity is any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States (collectively, in international water). For purposes of determining ocean activity, the Commissioner may separate parts of a single transaction into separate transactions or combine separate transactions as part of a single transaction. Paragraph (d)(3) of this section lists specific exceptions to the general definition of ocean activity. Activities that constitute ocean activity include but are not limited to—

(A) Performance and provision of services in international water, as defined in paragraph (d)(2)(ii) of this section;

(B) Leasing of equipment located in international water, including underwater cables;

(C) Licensing of technology or other intangibles for use in international water;

(D) Production, processing, or creation of property in international water, as defined in paragraph (d)(2)(i) of this section;

(E) Activity occurring in international water that is characterized as communications activity (other than international communications activity) under §1.863–9(h)(1);

(F) Underwriting income from the insurance of risks on activities that produce ocean income;

(G) Sales of property in international water (see §1.861–7(c)), but not sales of inventory property for use, consumption,

or disposition outside space or international water;

(H) Any activity performed in Antarctica;

(I) The leasing of a vessel that does not transport cargo or persons for hire between ports-of-call (for example, the leasing of a vessel to engage in research activities in international water); and

(J) The leasing of drilling rigs, extraction of minerals, and performance and provision of services related thereto, except as provided in paragraph (d)(3)(ii) of this section.

(2) *Determining a space or ocean activity*—(i) *Production of property in space or international water.* For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages property within the meaning of section 864(a) and §1.864–1.

(ii) *Special rule for performance of services*—(A) *General.* Except as provided in paragraph (d)(2)(ii)(B) of this section, if a transaction is characterized as the performance of a service, then such service will be treated as a space or ocean activity in its entirety when any part of the service is performed in space or international water. Services are performed in space or international water if functions are performed, resources are employed, or risks are assumed in space or international water, regardless of whether performed by personnel, equipment, or otherwise.

(B) *Exception to the general rule.* If the taxpayer can demonstrate the value of the service attributable to performance occurring in space or international water, and the value of the service attributable to performance occurring outside space and international water, then such service will be treated as space or ocean activity only to the extent of the activity performed in space or international water. The value of the service is attributable to performance occurring in space or international water to the extent the performance of the service, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in space or international water. In addition, if the taxpayer can demonstrate, based on all the facts and circumstances, that the value of the service attributable to performance in space or international wa-

ter is *de minimis*, such service will not be treated as space or ocean activity.

(3) *Exceptions to space or ocean activity.* Space or ocean activity does not include the following types of activities:

(i) Any activity giving rise to transportation income as defined in section 863(c).

(ii) Any activity with respect to mines, oil and gas wells, or other natural deposits, to the extent the mines, wells, or natural deposits are located within the jurisdiction (as recognized by the United States) of any country, including the United States and its possessions.

(iii) Any activity giving rise to international communications income as defined in §1.863-9(h)(3)(ii).

(e) *Treatment of partnerships.* This section is applied at the partner level.

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

Example 1. Space activity—activity occurring on land and in space—(i) Facts. S, a U.S. person, owns satellites in orbit. S leases one of its satellites to A. S, as lessor, will not operate the satellite. Part of S's performance as lessor in this transaction occurs on land. Assume that the combination of S's activities is characterized as the lease of equipment.

(ii) *Analysis.* Because the leased equipment is located in space, the transaction is defined as space activity under paragraph (d)(1)(i) of this section. Income derived from the lease will be sourced in its entirety under paragraph (b)(1) of this section. Under paragraph (b)(1) of this section, S's space income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Example 2. Space activity—(i) Facts. X is an Internet service provider. X offers a service that permits a customer (C) to connect to the Internet via a telephone call, initiated by the modem of C's personal computer, to a control center. X transmits information requested by C to C's personal computer, in part using satellite capacity leased by X from S. X charges its customers a flat monthly fee. Assume that neither X nor S derive international communications income within the meaning of §1.863-9(h)(3)(ii). In addition, assume that X is able to demonstrate, pursuant to paragraph (d)(2)(ii)(B) of this section, the extent to which the value of the service is attributable to functions performed, resources employed, and risks assumed in space.

(ii) *Analysis.* Under paragraph (d)(2)(ii) of this section, the service performed by X constitutes space activity to the extent the value of the service is attributable to functions performed, resources employed, and risks assumed in space. To the extent the service performed by X constitutes space activity, the source of X's income from the service transaction is determined under paragraph (b) of this section. To the extent the service performed by X does not constitute space or ocean activity, the source of X's income

from the service is determined under sections 861, 862, and 863, as applicable. To the extent that X derives space and ocean income that is also communications income within the meaning of §1.863-9(h)(2), the source of X's income is determined under paragraph (b) of this section and §1.863-9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. S derives space and ocean income that is also communications income within the meaning of §1.863-9(h)(2), and the source of S's income is therefore determined under paragraph (b) of this section and §1.863-9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 3. Services as space activity—de minimis value attributable to performance occurring in space—(i) Facts. R owns a retail outlet in the United States. R engages S to provide a security system for R's premises. S operates its security system by transmitting images from R's premises directly to a satellite, and from the satellite to a group of S employees located in Country B, who monitor the premises by viewing the transmitted images. O provides S with transponder capacity on O's satellite, which S uses to transmit those images. Assume that S's transaction with R is characterized as the performance of a service. Assume that O's provision of transponder capacity is also viewed as the provision of a service and that the value of O's service transaction attributable to performance in space is not *de minimis*. In addition, assume that S is able to demonstrate, pursuant to paragraph (d)(2)(ii) of this section, that a *de minimis* portion of the value of S's service transaction with R is attributable to performance in space. Assume also that S is able to demonstrate, pursuant to §1.863-9(h)(1), that the value of the transaction with R attributable to communications activities is *de minimis*.

(ii) *Analysis.* S derives income from providing monitoring services. Because S demonstrates that the value of S's service transaction attributable to performance in space is *de minimis*, S is not treated as engaged in a space activity, and none of S's income from the service transaction is space income. In addition, because S demonstrates that the value of the transaction with R attributable to communications activities is *de minimis*, S is not required under §1.863-9(h)(1)(ii) to treat the transaction as separate communications and non-communications transactions, and none of S's gross income from the transaction is treated as communications income within the meaning of §1.863-9(h)(2). Because O's provision of transponder capacity is viewed as the provision of a service and the value of O's service transaction attributable to performance in space is not *de minimis*, O's activity will be considered space activity, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of the services transaction is attributable to performance in space (unless O's activity in space is international communications activity). To the extent that O derives communications income, the source of such income is determined under paragraph (b) of this section and §1.863-9(b), (c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. R does not derive any income from space activity.

Example 4. Space activity—(i) Facts. L, a domestic corporation, offers programming and certain other services to customers located both in the United States and in foreign countries. Assume that L's pro-

vision of programming and other services in this Example 4 is characterized as the provision of a service, and that no part of the service transaction occurs in space or international water. Assume that the delivery of the programming constitutes a separate transaction also characterized as the performance of a service. L uses satellite capacity acquired from S to deliver the programming service directly to customers' television sets, so that part of the value of the delivery transaction derives from functions performed and resources employed in space. Assume that these contributions to the value of the delivery transaction occurring in space are not considered *de minimis* under paragraph (d)(2)(ii)(B) of this section. Customer C pays L to provide and deliver programming to C's residence in the United States. Assume S's provision of satellite capacity in this Example 4 is viewed as the provision of a service, and also that S does not derive international communications income within the meaning of §1.863-9(h)(3)(ii).

(ii) *Analysis.* S's activity will be considered space activity. To the extent that S derives space and ocean income that is also communications income under §1.863-9(h)(2), the source of S's income is determined under paragraph (b) of this section and §1.863-9(c), (d), and (f), as applicable, as provided in paragraph (b)(5) of this section. On these facts, L's activities are treated as two separate service transactions: the provision of programming (and other services), and the delivery of programming. L's income derived from provision of programming and other services is not income derived from space activity. L's delivery of programming and other services is considered space activity, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of the delivery transaction is attributable to performance in space. To the extent that the delivery of programming is treated as a space activity, the source of L's income derived from the delivery transaction is determined under paragraph (b)(1) of this section, as provided in paragraph (b)(4) of this section. To the extent that L derives space and ocean income that is also communications income within the meaning of §1.863-9(h)(2), the source of such income is determined under paragraph (b) of this section and §1.863-9(b), (c), (d), (e), and (f), as applicable, as provided in paragraph (b)(5) of this section.

Example 5. Space activity—treatment of land activity—(i) Facts. S, a U.S. person, offers remote imaging products and services to its customers. In year 1, S uses its satellite's remote sensors to gather data on certain geographical terrain. In year 3, C, a construction development company, contracts with S to obtain a satellite image of an area for site development work. S pulls data from its archives and transfers to C the images gathered in year 1, in a transaction that is characterized as a sale of the data. S's rights, title, and interest in the data pass to C in the United States. Before transferring the images to C, S uses computer software in its land-based office to enhance the images so that the images can be used.

(ii) *Analysis.* The collection of data and creation of images in space is characterized as the creation of property in space. Because S both produces and sells the data, S must allocate gross income from the sale of the data between production activity and sales activity under the 50/50 method of paragraph (b)(3)(ii)(A). The source of S's income allocable to production activity is determined under paragraph (b)(3)(ii)(C) of

this section because production activities occur both in space and on land. The source of S's income attributable to sales activity is determined under paragraph (b)(3)(ii)(D) of this section (by reference to §1.863-3(c)(2)) as U.S. source income because S's rights, title, and interest in the data pass to C in the United States.

Example 6. Use of intangible property in space—(i) Facts. X acquires a license to use a particular satellite slot or orbit, which X sublicenses to C. C pays X a royalty.

(ii) *Analysis.* Because the royalty is paid for the right to use intangible property in space, the source of the royalty paid by C to X is determined under paragraph (b) of this section.

Example 7. Performance of services—(i) Facts. E, a domestic corporation, operates satellites with sensing equipment that can determine how much heat and light particular plants emit and reflect. Based on the data, E will provide F, a U.S. farmer, a report analyzing the data, which F will use in growing crops. E analyzes the data from offices located in the United States. Assume that E's combined activities are characterized as the performance of services.

(ii) *Analysis.* E's activities will be considered space activities, pursuant to paragraph (d)(2)(ii) of this section, to the extent the value of E's service transaction is attributable to performance in space. To the extent E's service transaction constitutes a space activity, the source of E's income derived from the service transaction will be determined under paragraph (b)(4) of this section, by reference to paragraph (b)(1) of this section. To the extent that E's service transaction does not constitute a space or ocean activity, the source of E's income derived from the service transaction is determined under sections 861, 862, and 863, as applicable.

Example 8. Separate transactions—(i) Facts. The same facts as *Example 7*, except that E provides the raw data to F in a transaction characterized as a sale of a copyrighted article. In addition, E provides an analysis in the form of a report to F. The price F pays E for the raw data is separately stated.

(ii) *Analysis.* To the extent that the provision of raw data and the analysis of the data are each treated as separate transactions, the source of income from the production and sale of data is determined under paragraph (b)(3)(ii) of this section. The provision of services would be analyzed in the same manner as in *Example 7*.

Example 9. Sale of property in international water—(i) Facts. T purchased and owns transatlantic cable that lies in international water. T sells the cable to B, with T's rights, title, and interest in the cable passing to B in international water. Assume that the transatlantic cable is not inventory property within the meaning of section 1221(a)(1).

(ii) *Analysis.* Because T's rights, title, and interest in the property pass to B in international water, the sale takes place in international water under §1.861-7(c), and the sale transaction is ocean activity under paragraph (d)(1)(ii) of this section. The source of T's sales income is determined under paragraph (b)(3)(i) of this section, by reference to paragraph (b)(1) or (2) of this section.

Example 10. Sale of property in space—(i) Facts. S, a U.S. person, manufactures a satellite in the United States and sells it to a customer who is

not a U.S. person. S's rights, title, and interest in the satellite pass to the customer in space.

(ii) *Analysis.* Because S's rights, title, and interest in the satellite pass to the customer in space, the sale takes place in space under §1.861-7(c), and the sale transaction is space activity under paragraph (d)(1)(i) of this section. The source of income derived from the sale of the satellite in space is determined under paragraph (b)(3)(ii) of this section, with the source of income allocable to production activity determined under paragraphs (b)(3)(ii)(A) and (B) of this section, and the source of income allocable to sales activity determined under paragraphs (b)(3)(ii)(A) and (D) of this section. Under paragraph (b)(1) of this section, S's space income is sourced outside the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Example 11. Sale of property in space—(i) Facts. S has a right to operate from a particular position (satellite slot or orbit) in space. S sells the right to operate from that position to P. Assume that the sale of the satellite slot is characterized as a sale of property and that S's rights, title, and interest in the satellite slot pass to P in space.

(ii) *Analysis.* The sale of the satellite slot takes place in space under §1.861-7(c) because S's rights, title, and interest in the satellite slot pass to P in space. The sale of the satellite slot is space activity under paragraph (d)(1)(i) of this section, and income or gain from the sale is sourced under paragraph (b)(3)(i) of this section, by reference to paragraph (b)(1) or (2) of this section.

Example 12. Source of income of a foreign person—(i) Facts. FP, a foreign corporation that is not a CFC, derives income from the operation of satellites. FP operates ground stations in the United States and in foreign country FC. Assume that FP is considered engaged in a trade or business within the United States based on FP's operation of the ground station in the United States.

(ii) *Analysis.* Under paragraph (b)(2)(iii) of this section, FP's space income is sourced in the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

Example 13. Source of income of a foreign person—(i) Facts. FP, a foreign corporation that is not a CFC, operates remote sensing satellites in space to collect data and images for its customers. FP uses an independent agent, A, in the United States who provides marketing, order-taking, and other customer service functions. Assume that FP is considered engaged in a trade or business within the United States based on A's activities on FP's behalf in the United States.

(ii) *Analysis.* Under paragraph (b)(2)(iii) of this section, FP's space income is sourced in the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(g) *Reporting and documentation requirements—(1) General.* A taxpayer making an allocation of gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C),

or (b)(4) of this section must satisfy the requirements in paragraphs (g)(2), (3), and (4) of this section.

(2) *Required documentation.* In all cases, a taxpayer must prepare and maintain documentation in existence when its return is filed regarding the allocation of gross income and allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must make available such documentation within 30 days upon request.

(3) *Access to software.* If the taxpayer or any third party used any computer software, within the meaning of section 7612(d), to allocate gross income, or to allocate or apportion expenses, losses, and other deductions, the taxpayer must make available upon request—

(i) Any computer software executable code, within the meaning of section 7612(d), used for such purposes, including an executable copy of the version of the software used in the preparation of the taxpayer's return (including any plug-ins, supplements, etc.) and a copy of all related electronic data files. Thus, if software subsequently is upgraded or supplemented, a separate executable copy of the version used in preparing the taxpayer's return must be retained;

(ii) Any related computer software source code, within the meaning of section 7612(d), acquired or developed by the taxpayer or a related person, or primarily for internal use by the taxpayer or such person rather than for commercial distribution; and

(iii) In the case of any spreadsheet software or similar software, any formulae or links to supporting worksheets.

(4) *Use of allocation methodology.* In general, when a taxpayer allocates gross income under paragraph (b)(1), (b)(2), (b)(3)(ii)(C), or (b)(4) of this section, it does so by making the allocation on a timely filed original return (including extensions). However, a taxpayer will be permitted to make changes to such allocations made on its original return with respect to any taxable year for which the statute of limitations has not closed as follows:

(i) In the case of a taxpayer that has made a change to such allocations prior to the opening conference for the audit of

the taxable year to which the allocation relates or who makes such a change within 90 days of such opening conference, if the IRS issues a written information document request asking the taxpayer to provide the documents and such other information described in paragraphs (g)(2) and (3) of this section with respect to the changed allocations and the taxpayer complies with such request within 30 days of the request, then the IRS will complete its examination, if any, with respect to the allocations for that year as part of the current examination cycle. If the taxpayer does not provide the documents and information described in paragraphs (g)(2) and (3) of this section within 30 days of the request, then the procedures described in paragraph (g)(4)(ii) of this section shall apply.

(ii) If the taxpayer changes such allocations more than 90 days after the opening conference for the audit of the taxable year to which the allocations relate or the taxpayer does not provide the documents and information with respect to the changed allocations as requested in accordance with paragraphs (g)(2) and (3) of this section, then the IRS will, in a separate cycle, determine whether an examination of the taxpayer's allocations is warranted and complete any such examination. The separate cycle will be worked as resources are available and may not have the same estimated completion date as the other issues under examination for the taxable year. The IRS may ask the taxpayer to extend the statute of limitations on assessment and collection for the taxable year to permit examination of the taxpayer's method of allocation, including an extension limited, where appropriate, to the taxpayer's method of allocation.

(h) *Effective date.* This section applies to taxable years beginning on or after the date of publication of final regulations in the **Federal Register**.

§1.863-9 Source of income derived from communications activity under sections 863(a), (d), and (e).

(a) *In general.* Income of a United States or a foreign person derived from each type of communications activity, as defined in paragraph (h)(3) of this section, is sourced under the rules of this section, notwithstanding any other provision including sections 861, 862, 863, and

865. Notwithstanding that a communications activity would qualify as space or ocean activity under section 863(d) and the regulations thereunder, the source of income derived from such communications activity is determined under this section, and not under section 863(d) and the regulations thereunder, except to the extent provided in §1.863-8(b)(5).

(b) *Source of international communications income—(1) International communications income derived by a U.S. person.* Income derived from international communications activity (international communications income) by a U.S. person is one-half from sources within the United States and one-half from sources without the United States.

(2) *International communications income derived by foreign persons—(i) In general.* International communications income derived by a person other than a U.S. person is, except as otherwise provided in this paragraph (b)(2), wholly from sources without the United States.

(ii) *International communications income derived by a controlled foreign corporation.* International communications income derived by a controlled foreign corporation within the meaning of section 957 (CFC) is one-half from sources within the United States and one-half from sources without the United States.

(iii) *International communications income derived by foreign persons with a fixed place of business in the United States.* International communications income derived by a foreign person, other than a CFC, that is attributable to an office or other fixed place of business of the foreign person in the United States is from sources within the United States. The principles of section 864(c)(5) apply in determining whether a foreign person has an office or fixed place of business in the United States. See §1.864-7. International communications income is attributable to an office or other fixed place of business to the extent of functions performed, resources employed, or risks assumed by the office or other fixed place of business.

(iv) *International communications income derived by foreign persons engaged in a trade or business within the United States.* International communications income derived by a foreign person (other than a CFC) engaged in a trade or business within the United States is income from

sources within the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed within the United States.

(c) *Source of U.S. communications income.* Income derived by a United States or foreign person from U.S. communications activity is from sources within the United States.

(d) *Source of foreign communications income.* Income derived by a United States or foreign person from foreign communications activity is from sources without the United States.

(e) *Source of space/ocean communications income.* The source of income derived by a United States or foreign person from space/ocean communications activity is determined under section 863(d) and the regulations thereunder.

(f) *Source of communications income when taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication.* Income derived by a United States or foreign person from communications activity, when the taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication as required in paragraph (h)(3)(i) of this section, is from sources within the United States.

(g) *Taxable income.* When a taxpayer allocates gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section, the taxpayer must allocate expenses, losses, and other deductions as prescribed in §§1.861-8 through 1.861-14T to the class or classes of gross income that include the income so allocated in each case. A taxpayer must then apply the rules of §§1.861-8 through 1.861-14T properly to apportion amounts of expenses, losses, and other deductions so allocated to such gross income between gross income from sources within the United States and gross income from sources without the United States. For amounts of expenses, losses, and other deductions allocated to gross income derived from international communications activity, when the source of income is determined under the 50/50 method of paragraph (b)(1) or (b)(2)(ii) of this section, taxpayers generally must apportion expenses, losses, and other deductions between sources within the United States and sources without the United States *pro rata* based on the rela-

tive amounts of gross income from sources within the United States and gross income from sources without the United States. However, the preceding sentence shall not apply to research and experimental expenditures qualifying under §1.861-17, which are to be allocated and apportioned under the rules of that section.

(h) *Communications activity and income derived from communications activity*—(1) *Communications activity*—(i) *General rule*. For purposes of this part, *communications activity* consists solely of the delivery by transmission of communications or data (communications). Delivery of communications other than by transmission (for example, by delivery of physical packages and letters) is not communications activity within the meaning of this section. Communications activity also includes the provision of capacity to transmit communications. Provision of content or any other additional service provided along with, or in connection with, a non-*de minimis* communications activity must be treated as a separate non-communications activity unless *de minimis*. Communications activity or non-communications activity will be treated as *de minimis* to the extent, based on the facts and circumstances, the value attributable to such activity is *de minimis*.

(ii) *Separate transaction*. To the extent that a taxpayer's transaction consists in part of non-*de minimis* communications activity and in part of non-*de minimis* non-communications activity, each such part of the transaction must be treated as a separate transaction. Gross income is allocated to each such communications activity transaction and non-communications activity transaction to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in each such activity.

(2) *Income derived from communications activity*. *Income derived from communications activity* (communications income) is income derived from the delivery by transmission of communications, including income derived from the provision of capacity to transmit communications. Income may be considered derived from a communications activity even if the taxpayer itself does not perform the transmission function, but in all cases, the taxpayer derives communications income

only if the taxpayer is paid to transmit, and bears the risk of transmitting, the communications.

(3) *Determining the type of communications activity*—(i) *In general*. Whether income is derived from international communications activity, U.S. communications activity, foreign communications activity, or space/ocean communications activity is determined by identifying the two points between which the taxpayer is paid to transmit the communication. The taxpayer must establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication. Whether the taxpayer contracts out part or all of the transmission function is not relevant.

(ii) *Income derived from international communications activity*. *Income derived by a taxpayer from international communications activity* (international communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit between a point in the United States and a point in a foreign country (or a possession of the United States).

(iii) *Income derived from U.S. communications activity*. *Income derived by a taxpayer from U.S. communications activity* (U.S. communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit—

(A) Between two points in the United States; or

(B) Between the United States and a point in space or international water.

(iv) *Income derived from foreign communications activity*. *Income derived by a taxpayer from foreign communications activity* (foreign communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit—

(A) Between two points in a foreign country or countries (or a possession or possessions of the United States);

(B) Between a foreign country and a possession of the United States; or

(C) Between a foreign country (or a possession of the United States) and a point in space or international water.

(v) *Income derived from space/ocean communications activity*. *Income derived by a taxpayer from space/ocean communications activity* (space/ocean communications income) is income derived from communications activity, as defined in paragraph (h)(2) of this section, when the taxpayer is paid to transmit between a point in space or international water and another point in space or international water.

(i) *Treatment of partnerships*. This section is applied at the partner level.

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

Example 1. Income derived from non-communications activity—remote data base access—(i) *Facts*. D provides its customers in various foreign countries with access to its data base, which contains information on certain individuals' health care insurance coverage. Customer C obtains access to D's data base by placing a call to D's telephone number. Assume that C's telephone service, used to access D's data base, is provided by a third party, and that D assumes no responsibility for the transmission of the information via telephone.

(ii) *Analysis*. D is not paid to transmit communications and does not derive income from communications activity within the meaning of paragraph (h)(2) of this section. Rather, D derives income from provision of content or provision of services to its customers. Therefore, the rules of this section do not apply to determine the source of D's income.

Example 2. Income derived from U.S. communications activity—U.S. portion of international communication—(i) *Facts*. TC, a local telephone company, receives an access fee from an international carrier for picking up a call from a local telephone customer and delivering the call to a U.S. point of presence (POP) of the international carrier. The international carrier picks up the call from its U.S. POP and delivers the call to a foreign country.

(ii) *Analysis*. TC is not paid to carry the transmission between the United States and a foreign country. TC is paid to transmit a communication between two points in the United States. TC derives U.S. communications income as defined in paragraph (h)(3)(iii) of this section, which is sourced under paragraph (c) of this section as U.S. source income.

Example 3. Income derived from international communications activity—underwater cable—(i) *Facts*. TC, a domestic corporation, owns an underwater fiber optic cable. Pursuant to contracts, TC makes available to its customers capacity to transmit communications via the cable. TC's customers then solicit telephone customers and arrange to transmit the telephone customers' calls. The cable runs in part through U.S. waters, in part through international waters, and in part through foreign country waters.

(ii) *Analysis*. TC derives international communications income as defined in paragraph (h)(3)(ii) of this section because TC is paid to make available capacity to transmit communications between the United States and a foreign country. Because TC is a U.S. person, TC's international communications income is sourced under paragraph (b)(1) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 4. Income derived from international communications activity—satellite—(i) Facts. S, a U.S. person, owns satellites in orbit and uplink facilities in Country X, a foreign country. B, a resident of Country X, pays S to deliver B's programming from S's uplink facility, located in Country X, to a downlink facility in the United States owned by C, a customer of B.

(ii) *Analysis.* S derives international communications income under paragraph (h)(3)(ii) of this section because S is paid to transmit the communications between a beginning point in a foreign country and an endpoint in the United States. Because S is a U.S. person, the source of S's international communications income is determined under paragraph (b)(1) of this section as one-half from sources within the United States and one-half from sources without the United States.

Example 5. The paid-to-do rule—foreign communications via domestic route—(i) Facts. TC is paid to transmit communications from Toronto, Canada, to Paris, France. TC transmits the communications from Toronto to New York. TC pays another communications company, IC, to transmit the communications from New York to Paris.

(ii) *Analysis.* Under the *paid-to-do* rule of paragraph (h)(3)(i) of this section, TC derives foreign communications income under paragraph (h)(3)(iv) of this section because TC is paid to transmit communications between two points in foreign countries, Toronto and Paris. Under paragraph (h)(3)(i) of this section, the character of TC's communications activity is determined without regard to the fact that TC pays IC to transmit the communications for some portion of the delivery path. IC has international communications income under paragraph (h)(3)(ii) of this section because IC is paid to transmit the communications between a point in the United States and a point in a foreign country.

Example 6. The paid-to-do rule—domestic communication via foreign route—(i) Facts. TC is paid to transmit a call between two points in the United States, but routes the call through Canada.

(ii) *Analysis.* Under paragraph (h)(3)(i) of this section, the character of income derived from communications activity is determined by the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communications, without regard to the path of the transmission between those two points. Thus, under paragraph (h)(3)(iii) of this section, TC derives income from U.S. communications activity because it is paid to transmit the communications between two U.S. points.

Example 7. Indeterminate endpoints—prepaid telephone calling cards—(i) Facts. S purchases capacity from TC to transmit telephone calls. S sells prepaid telephone calling cards that give customers access to TC's telephone lines for a certain number of minutes. Assume that S cannot establish the endpoints of its customers' telephone calls.

(ii) *Analysis.* S derives communications income as defined in paragraph (h)(2) of this section because S makes capacity to transmit communications available to its customers. In this case, S cannot establish the two points between which the communications are transmitted. Therefore, S's communications income is U.S. source income, as provided by paragraph (f) of this section.

Example 8. Indeterminate endpoints—Internet access—(i) Facts. B, a domestic corporation, is an Internet service provider. B charges its customer, C, a monthly lump sum for Internet access. C accesses the Internet via a telephone call, initiated by the modem of C's personal computer, to one of B's control centers, which serves as C's portal to the Internet. B transmits data sent by C from B's control center in France to a recipient in England, over the Internet. B does not maintain records as to the beginning and endpoints of the transmission.

(ii) *Analysis.* B derives communications income as defined in paragraph (h)(2) of this section. The source of B's communications income is determined under paragraph (f) of this section as income from sources within the United States because B cannot establish the two points between which it is paid to transmit the communications.

Example 9. De minimis non-communications activity—(i) Facts. The same facts as in *Example 8*. Assume in addition that B replicates frequently requested sites on B's own servers, solely to speed up response time. Assume that B's replication of frequently requested sites would be considered a *de minimis* non-communications activity under this section.

(ii) *Analysis.* On these facts, because B's replication of frequently requested sites would be considered a *de minimis* non-communications activity, B is not required to treat the replication activity as a separate non-communications activity transaction under paragraph (h)(1) of this section. B derives communications income under paragraph (h)(2) of this section. The character and source of B's communications income are determined by demonstrating the points between which B is paid to transmit the communications, under paragraph (h)(3)(i) of this section.

Example 10. Income derived from communications and non-communications activity—bundled services—(i) Facts. A, a domestic corporation, offers customers local and long distance phone service, video, and Internet services. Customers pay a flat monthly fee plus 10 cents a minute for all long-distance calls, including international calls.

(ii) *Analysis.* Under paragraph (h)(1)(ii) of this section, to the extent that A's transaction with its customer consists in part of non-*de minimis* communications activity and in part of non-*de minimis* non-communications activity, each such part of the transaction must be treated as a separate transaction. A's gross income from the transaction is allocated to each such communications activity transaction and non-communications activity transaction in accordance with paragraph (h)(1)(ii) of this section. To the extent A can establish that it derives international communications income as defined in paragraph (h)(3)(ii) of this section, A would determine the source of such income under paragraph (b)(1) of this section. If A cannot establish the points between which it is paid to transmit communications, as required by paragraph (h)(3)(i) of this section, A's communications income is from sources within the United States, as provided by paragraph (f) of this section.

Example 11. Income derived from communications and non-communications activity—(i) Facts. B, a domestic corporation, is paid by D, a cable system operator in Foreign Country, to provide television programs and to transmit the television programs to Foreign Country. Using its own satellite transponder, B transmits the television programs from the United

States to downlink facilities owned by D in Foreign Country. D receives the transmission, unscrambles the signals, and distributes the broadcast to D's customers in Foreign Country. Assume that B's provision of television programs is a non-*de minimis* non-communications activity, and that B's transmission of television programs is a non-*de minimis* communications activity.

(ii) *Analysis.* Under paragraph (h)(1)(ii) of this section, B must treat its communications and non-communications activities as separate transactions. B's gross income is allocated to each such separate communications and non-communications activity transaction in accordance with paragraph (h)(1)(ii) of this section. Income derived by B from the transmission of television programs to D's Foreign Country downlink facility is international communications income as defined in paragraph (h)(3)(ii) of this section because B is paid to transmit communications from the United States to a foreign country.

Example 12. Income derived from foreign communications activity—(i) Facts. S provides satellite capacity to B, a broadcaster located in Australia. B beams programming from Australia to the satellite. S's satellite picks the communications up in space and beams the programming over a footprint covering Southeast Asia.

(ii) *Analysis.* S derives communications income as defined in paragraph (h)(2) of this section. S's income is characterized as foreign communications income under paragraph (h)(3)(iv) of this section because S picks up the communication in space, and beams it to a footprint entirely covering a foreign area. Under paragraph (d) of this section, S's foreign communications income is from sources without the United States. If S were beaming the programming over a satellite footprint that covered area both in the United States and outside the United States, S would be required to allocate the income derived from the different types of communications activity.

(k) *Reporting and documentation requirements—(1) In general.* A taxpayer making an allocation of gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section must satisfy the requirements in paragraphs (k)(2) and (3) of this section.

(2) *Required documentation.* In all cases, a taxpayer must prepare and maintain documentation in existence when its return is filed regarding the allocation of gross income, and allocation and apportionment of expenses, losses, and other deductions, the methodologies used, and the circumstances justifying use of those methodologies. The taxpayer must make available such documentation within 30 days upon request.

(3) *Access to software.* If the taxpayer or any third party used any computer software, within the meaning of section 7612(d), to allocate gross income, or to allocate or apportion expenses, losses, and

other deductions, the taxpayer must make available upon request—

(i) Any computer software executable code, within the meaning of section 7612(d), used for such purposes, including an executable copy of the version of the software used in the preparation of the taxpayer's return (including any plug-ins, supplements, etc.) and a copy of all related electronic data files. Thus, if software subsequently is upgraded or supplemented, a separate executable copy of the version used in preparing the taxpayer's return must be retained;

(ii) Any related computer software source code, within the meaning of section 7612(d), acquired or developed by the taxpayer or a related person, or primarily for internal use by the taxpayer or such person rather than for commercial distribution; and

(iii) In the case of any spreadsheet software or similar software, any formulae or links to supporting worksheets.

(4) *Use of allocation methodology.* In general, when a taxpayer allocates gross income under paragraph (b)(2)(iii), (b)(2)(iv), or (h)(1)(ii) of this section, it does so by making the allocation on a timely filed original return (including extensions). However, a taxpayer will be permitted to make changes to such allocations made on its original return with respect to any taxable year for which the statute of limitations has not closed as follows:

(i) In the case of a taxpayer that has made a change to such allocations prior to the opening conference for the audit of the taxable year to which the allocation relates or who makes such a change within 90 days of such opening conference, if the IRS issues a written information document request asking the taxpayer to provide the documents and such other information described in paragraphs (k)(2) and (3) of this section with respect to the changed allocations and the taxpayer complies with such request within 30 days of the request, then the IRS will complete its examination, if any, with respect to the allocations for that year as part of the current examination cycle. If the taxpayer does not provide the documents and information described in paragraphs (k)(2) and (3) of this section within 30 days of the request, then the procedures described in paragraph (k)(4)(ii) of this section shall apply.

(ii) If the taxpayer changes such allocations more than 90 days after the opening conference for the audit of the taxable year to which the allocations relate or the taxpayer does not provide the documents and information with respect to the changed allocations as requested in accordance with paragraphs (k)(2) and (3) of this section, then the IRS will, in a separate cycle, determine whether an examination of the taxpayer's allocations is warranted and complete any such examination. The separate cycle will be worked as resources are available and may not have the same estimated completion date as the other issues under examination for the taxable year. The IRS may ask the taxpayer to extend the statute of limitations on assessment and collection for the taxable year to permit examination of the taxpayer's method of allocation, including an extension limited, where appropriate, to the taxpayer's method of allocation.

(1) *Effective date.* This section applies to taxable years beginning on or after the date of publication of final regulations in the **Federal Register**.

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

(Filed by the Office of the Federal Register on September 16, 2005, 8:45 a.m., and published in the issue of the Federal Register for September 19, 2005, 70 F.R. 54859)

Notice of Proposed Rulemaking

Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or if an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transaction(s)

REG-111257-05

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that clarify the substantive requirements for tax exemption under section 501(c)(3) of the Internal Revenue Code (Code). This document also contains

provisions that clarify the relationship between the substantive requirements for tax exemption under section 501(c)(3) and the imposition of section 4958 excise taxes.

DATES: Written comments and requests for a public hearing must be received by December 8, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-111257-05), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-111257-05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at www.irs.gov/regs or the Federal eRule-making Portal at www.regulations.gov (IRS-REG-111257-05). A public hearing may be scheduled if requested.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Galina Kolomietz, (202) 622-4441; Concerning submission of comments and requests for a public hearing, Richard Hurst, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. Section 501(c)(3) and the Regulations Thereunder

To be described in section 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, or educational purposes. In addition, no part of the net earnings of the organization may inure to the benefit of any private shareholder or individual, no substantial part of the organization's activities may include attempts to influence legislation, and the organization may not intervene in political campaigns.

Existing regulations under section 501(c)(3) were adopted in substantially their present form in 1959. In explaining and clarifying the statutory requirements, these regulations provide that, to be described in section 501(c)(3), an organization must be both organized and operated

for exempt purposes. An organization is not operated exclusively for exempt purposes and, thus, is not described in section 501(c)(3), if any of its net earnings inure to the benefit of a private shareholder or individual. §1.501(c)(3)-1(c)(2). The regulations define private shareholder or individual as referring to persons having a personal and private interest in the activities of the organization. §1.501(a)-1(c).

In addition, an organization is not organized or operated for one or more of the exempt purposes enumerated in §1.501(c)(3)-1(d)(1)(i) and, thus, is not described in section 501(c)(3), if it is organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such interests. §1.501(c)(3)-1(d)(1)(ii).

These proposed regulations amend the regulations under section 501(c)(3), adding several examples to illustrate the requirement in §1.501(c)(3)-1(d)(1)(ii) that an organization serve a public rather than a private interest. The examples illustrate that prohibited private benefits may involve non-economic benefits as well as economic benefits. In addition, prohibited private benefit may arise regardless of whether payments made to private interests are reasonable or excessive. The examples reflect current law.

B. Section 4958 and the Regulations Thereunder

Section 4958 was added to the Code by the Taxpayer Bill of Rights 2, Public Law 104-168 (110 Stat. 1452; July 30, 1996). Section 4958 imposes certain excise taxes on transactions that provide excess economic benefits to disqualified persons with respect to public charities and social welfare organizations described in sections 501(c)(3) and 501(c)(4), respectively. These organizations are collectively referred to as *applicable tax-exempt organizations*. Section 4958(e). An excess benefit is the amount by which the value of an economic benefit provided by an applicable tax-exempt organization directly or indirectly to or for the use of a disqualified person exceeds the value of the consideration (including the performance of services) received for providing such benefit. §53.4958-1(b). A disqualified person is

defined as a person who is in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization. Section 4958(f)(1). Section 4958(a) imposes the liability for excise taxes on *disqualified persons* who receive an excess benefit from, and on *certain organization managers* who knowingly participate in, an excess benefit transaction. Section 4958 imposes no corresponding sanctions on *exempt organizations*. The section 4958 excise taxes generally apply to excess benefit transactions occurring on or after September 14, 1995.

On August 4, 1998, a notice of proposed rulemaking (REG-246256-96, 1998-2 C.B. 224) clarifying certain definitions and rules contained in section 4958 was published in the **Federal Register** (63 FR 41486). Those 1998 proposed regulations were revised in response to written and oral comments and replaced by temporary and proposed regulations on January 10, 2001 (T.D. 8920, 2001-1 C.B. 654 [66 FR 2144], and REG-246256-96, 2001-1 C.B. 712 [66 FR 2173]). Final regulations under section 4958 were published on January 23, 2002 (T.D. 8978, 2002-1 C.B. 500 [67 FR 3076]).

C. History of the Relationship Between Section 4958 Taxes and Tax-Exempt Status

Section 501(c)(3) and the longstanding regulations thereunder establish certain tests that an organization must meet to qualify for tax-exempt status. §1.501(c)(3)-1(a)(1). Section 4958, by its terms, does not address the tax-exempt status of applicable tax-exempt organizations, but instead imposes excise tax liability on disqualified persons and certain organization managers.

In the 1996 House Report on section 4958, Congress briefly addressed the relationship between section 4958 and tax-exempt status. Specifically, the Report stated that these “intermediate sanctions for excess benefit transactions may be imposed by the IRS in lieu of (*or in addition to*) revocation of the organization’s tax-exempt status.” H. Rep. No. 104-506, 104th Cong., 2d Sess., at 59 (1996) (emphasis added). The Report also stated, in a footnote, that, in general, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only if an organization no longer operates as a charita-

ble organization. H. Rep. No. 104-506, 104th Cong., 2d Sess., at 59, note 15.

In keeping with the differences between section 501(c)(3) and section 4958, the Treasury Department and the IRS consistently have taken the position that the imposition of excise taxes under section 4958 does not foreclose revocation of tax-exempt status in appropriate cases. The 1998 proposed regulations under section 4958 stated that “[t]he excise taxes imposed by section 4958 do not affect the substantive statutory standards for tax exemption under section 501(c)(3) or (4).” Proposed §53.4958-7(a), (63 FR 41,505). Both the 2001 temporary and the 2002 final regulations stated that—

Section 4958 does not affect the substantive standards for tax exemption under section 501(c)(3) or (4), including the requirements that the organization be organized and operated exclusively for exempt purposes, and that no part of its net earnings inure to the benefit of any private shareholder or individual. Thus, regardless of whether a particular transaction is subject to excise taxes under section 4958, existing principles and rules may be implicated, such as the limitation on private benefit. (26 CFR 53.4958-8(a)).

The preamble to the 1998 proposed regulations under section 4958 stated that the IRS will exercise its administrative discretion in enforcing the requirements of sections 4958, 501(c)(3), and 501(c)(4). The preamble to the 1998 proposed regulations listed the following four factors the IRS will consider in determining whether an applicable tax-exempt organization described in section 501(c)(3) continues to be described in section 501(c)(3) in cases in which section 4958 excise taxes are also imposed: (1) Whether the organization has been involved in repeated excess benefit transactions; (2) the size and the scope of the excess benefit transactions; (3) whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and (4) whether there was compliance with other applicable laws. (63 FR 41,488 through 41,489).

The preamble to the 2001 temporary regulations stated that the IRS intends to publish guidance regarding the factors it will consider as it gains more experience

in administering section 4958. The preamble to the 2002 final regulations stated that, until such guidance is published, the IRS will consider all relevant facts and circumstances in the administration of section 4958 cases. These proposed regulations amend the regulations under section 501(c)(3) to provide guidance on certain factors that the IRS will consider in determining whether an applicable tax-exempt organization described in section 501(c)(3) that engages in one or more excess benefit transactions continues to be described in section 501(c)(3).

D. Section 4958 and Application for Recognition of Tax-Exempt Status Under Section 501(c)(3)

Section 4958 and the regulations thereunder do not apply to organizations that are not applicable tax-exempt organizations as defined therein. These proposed regulations amend the regulations under section 4958 to clarify that the IRS has discretion to refuse to issue a ruling recognizing exemption under section 501(c)(3) to any applicant whose purpose or activities violate any provision of section 501(c)(3), including the inurement prohibition and the limitation on private benefit, even though such violation could serve as grounds for imposing section 4958 excise taxes if the applicant's tax-exempt status were recognized.

E. Proposed Effective Date

These regulations are proposed to be applicable on the date of publication in the **Federal Register** of a Treasury Decision adopting them as final regulations.

Special Analyses

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

posed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by a person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Galina Kolomietz and Phyllis Haney, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 53 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.501(c)(3)-1, paragraph (d)(1)(iii) is redesignated as paragraph (d)(1)(iv).

Par. 3. In §1.501(c)(3)-1, paragraphs (d)(1)(iii) and (g) are added to read as follows:

§1.501(c)(3)-(1) Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for

the prevention of cruelty to children or animals.

* * * * *

(d) * * *

(1) * * *

(iii) *Examples.* The following examples illustrate the requirement of paragraph (d)(1)(ii) of this section that an organization serve a public rather than a private interest:

Example 1. (i) O is an educational organization the purpose of which is to study history and immigration. The focus of O's historical studies is the genealogy of one family, tracing the descent of its present members. O actively solicits for membership only individuals who are members of that one family. O's research is directed toward publishing a history of that family that will document the pedigrees of family members. A major objective of O's research is to identify and locate living descendants of that family to enable those descendants to become acquainted with each other.

(ii) O's educational activities primarily serve the private interests of members of a single family rather than a public interest. Therefore, O is operated for the benefit of private interests in violation of the restriction on private benefit in §1.501(c)(3)-1(d)(1)(ii). Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Example 2. (i) O is an art museum. O's sole activity is exhibiting art created by a group of unknown but promising local artists. O is governed by a board of trustees unrelated to the artists whose work O exhibits. All of the art exhibited is offered for sale at prices set by the artist. Each artist whose work is exhibited has a consignment arrangement with O. Under this arrangement, when art is sold, the museum retains 10 percent of the selling price to cover the costs of operating the museum and gives the artist 90 percent.

(ii) The artists in this situation directly benefit from the exhibition and sale of their art. As a result, the sole activity of O serves the private interests of these artists. Because O gives 90 percent of the proceeds from its sole activity to the individual artists, the direct benefits to the artists are substantial and O's provision of these benefits to the artists is more than incidental to its other purposes and activities. This arrangement causes O to be operated for the benefit of private interests in violation of the restriction on private benefit in §1.501(c)(3)-1(d)(1)(ii). Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Example 3. (i) O is an educational organization the purpose of which is to train individuals in a program developed by P, O's president. All of the rights to the program are owned by Company K, a for-profit corporation owned by P. Prior to the existence of O, the teaching of the program was conducted by Company K. O licenses, from Company K, the right to use a reference to the program in O's name and the right to teach the program, in exchange for specified royalty payments. Under the license agreement, Company K provides O with the services of trainers and

with course materials on the program. O may develop and copyright new course materials on the program but all such materials must be assigned to Company K without consideration if the license agreement is terminated. Company K sets the tuition for the seminars and lectures on the program conducted by O. O has agreed not to become involved in any activity resembling the program or its implementation for 2 years after the termination of O's license agreement.

(ii) O's sole activity is conducting seminars and lectures on the program. This arrangement causes O to be operated for the benefit of P and Company K in violation of the restriction on private benefit in §1.501(c)(3)-1(d)(1)(ii), regardless of whether the royalty payments from O to Company K for the right to teach the program are reasonable. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

* * * * *

(g) *Interaction with section 4958*—(1) *Application process.* An organization that applies for recognition of exemption under section 501(a) as an organization described in section 501(c)(3) must establish its eligibility under this section. The Commissioner may deny an application for exemption for failure to establish any of this section's requirements for exemption. Section 4958 does not apply to transactions with an organization that has failed to establish that it satisfies all of the requirements for exemption under section 501(c)(3). See §53.4958-2 of this chapter.

(2) *Substantive requirements for exemption still apply to applicable tax-exempt organizations described in section 501(c)(3)*—(i) *In general.* Regardless of whether a particular transaction is subject to excise taxes under section 4958, the substantive requirements for tax exemption under section 501(c)(3) still apply to an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958-2 of this chapter) described in section 501(c)(3) whose disqualified persons or organization managers are subject to excise taxes under section 4958. Accordingly, an organization may no longer meet the requirements for tax-exempt status under section 501(c)(3) because the organization fails to satisfy the requirements of paragraph (b), (c) or (d) of this section. See §53.4958-8(a) of this chapter.

(ii) *Determining whether revocation of tax-exempt status is appropriate when section 4958 excise taxes also apply.* In determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization (as defined in sec-

tion 4958(e) and §53.4958-2 of this chapter) described in section 501(c)(3) that engages in one or more excess benefit transactions (as defined in section 4958(c) and §53.4958-4 of this chapter) that violate the prohibition on inurement under this section, the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following—

(A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;

(B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;

(C) Whether the organization has been involved in repeated excess benefit transactions;

(D) Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations; and

(E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and §53.4958-7 of this chapter), or the organization has made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transaction.

(iii) All factors will be considered in combination with each other. Depending on the particular situation, the Commissioner may assign greater or lesser weight to some factors than to others. The factors listed in paragraphs (g)(2)(ii)(D) and (E) of this section will weigh more strongly in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner discovers the excess benefit transaction or transactions. Further, with respect to the factor listed in paragraph (g)(2)(ii)(E) of this section, correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

(iv) *Examples.* The following examples illustrate the principles of paragraph (g)(2)(ii) of this section. For purposes of each example, assume that O is an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958-2 of this

chapter) described in section 501(c)(3) for all relevant periods. The examples are as follows:

Example 1. (i) O was created as a museum for the purpose of exhibiting art to the general public. In Years 1 and 2, O engages in fundraising and in selecting, leasing, and preparing an appropriate facility for a museum. In Year 3, a new board of trustees is elected. All of the new trustees are local art dealers. Beginning in Year 3 and continuing to the present, O uses almost all of its revenues to purchase art solely from its trustees at prices that exceed fair market value. O exhibits and offers for sale all of the art it purchases. O's Form 1023, "Application for Recognition of Exemption," did not disclose the possibility that O's trustees would be selling art to O.

(ii) O's purchases of art from its trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the appropriate excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. Beginning in Year 3, O does not engage in any regular and ongoing activities that further exempt purposes because almost all of O's activities consist of purchasing art from its trustees and exhibiting and offering for sale all of the art it purchases. The size and scope of the excess benefit transactions collectively are significant in relation to the size and scope of any of O's ongoing activities that further exempt purposes. O has been involved in repeated excess benefit transactions, namely, purchases of art from its trustees at more than fair market value. O has not implemented safeguards that are reasonably calculated to prevent such improper purchases in the future. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transactions (the trustees). The trustees continue to control O's Board. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 3.

Example 2. (i) The facts are the same as in *Example 1*, except that in Year 4, O's entire board of trustees resigns, and O no longer offers all exhibited art for sale. The former board is replaced with members of the community who are not in the business of buying or selling art and who have skills and experience running educational programs and institutions. O promptly discontinues the practice of purchasing art from current or former trustees, adopts a written conflicts of interest policy, adopts written art valuation guidelines, hires legal counsel to recover the excess amounts O had paid its former trustees, and implements a new program of educational activities.

(ii) O's purchases of art from its former trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the appropriate excise taxes provided in that section. In addition, O's purchases of art from its trustees

at more than fair market value violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. In Year 3, O does not engage in any regular and ongoing activities that further exempt purposes. However, in Year 4, O elects a new board of trustees comprised of individuals who have skills and experience running educational programs and implements a new program of educational activities. As a result of these actions, beginning in Year 4, O engages in regular and ongoing activities that further exempt purposes. The size and scope of the excess benefit transactions that occurred in Year 3, taken collectively, are significant in relation to the size and scope of O's regular and ongoing exempt function activities that were conducted in Year 3. Beginning in Year 4, however, as O's exempt function activities are established and grow, the size and scope of the excess benefit transactions that occurred in Year 3 become less and less significant as compared to the size and extent of O's regular and ongoing exempt function activities that began in Year 4 and continued thereafter. O was involved in repeated excess benefit transactions in Year 3. However, by discontinuing its practice of purchasing art from its current and former trustees, by replacing its former board with independent members of the community, and by adopting a conflicts of interest policy and art valuation guidelines, O has implemented safeguards that are reasonably calculated to prevent future violations. In addition, O has made a good faith effort to seek correction from the disqualified persons who benefited from the excess benefit transactions (its former trustees). Based on the application of the factors to these facts, O continues to meet the requirements for tax exemption under section 501(c)(3).

Example 3. (i) O conducts educational programs for the benefit of the general public. Since its formation, O has employed its founder, C, as its Chief Executive Officer. Beginning in Year 5 of O's operations and continuing to the present, C caused O to divert significant portions of O's funds to pay C's personal expenses. The diversions by C significantly reduced the funds available to conduct O's ongoing educational programs. The board of trustees never authorized C to cause O to pay C's personal expenses from O's funds. Certain members of the board were aware that O was paying C's personal expenses. However, the board did not terminate C's employment and did not take any action to seek repayment from C or to prevent C from continuing to divert O's funds to pay C's personal expenses. C claimed that O's payments of C's personal expenses represented loans from O to C. However, no contemporaneous loan documentation exists, and C never made any payments of principal or interest.

(ii) The diversions of O's funds to pay C's personal expenses constituted excess benefit transactions between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, these transactions are subject to the appropriate excise taxes provided in that section. In addition, these transactions violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. However, the size and scope of the excess benefit transactions engaged in by O beginning in Year 5, collectively, are significant in relation to the size and scope of O's activities that further exempt purposes. Moreover, O has been involved in repeated excess benefit transactions. O has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from C, the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 5.

Example 4. (i) O conducts activities that further exempt purposes. O employs C as its Chief Executive Officer. C, on behalf of O, entered into a contract with Company K to construct an addition to O's existing building. The addition to O's building is a significant undertaking in relation to O's other activities. C owns all of the voting stock of Company K. Under the contract, O paid Company K an amount that substantially exceeded the fair market value of the services Company K provided. When O's board of trustees approved the contract with Company K, the board did not perform due diligence that could have made it aware that the contract price for Company K's services was excessive. Subsequently, but before the IRS commences an examination of O, O's board of trustees determines that the contract price was excessive. Thus, O concludes that an excess benefit transaction has occurred. After the board makes this determination, it promptly removes C as Chief Executive Officer, terminates C's employment with O, and hires legal counsel to recover the excess payments to Company K. In addition, O promptly adopts a conflicts of interest policy and significant new contract review procedures designed to prevent future recurrences of this problem.

(ii) The purchase of services by O from Company K at more than fair market value constitutes an excess benefit transaction between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, this transaction is subject to the appropriate excise taxes provided in that section. In addition, this transaction violates the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transaction occurred. Although the size and scope of the excess benefit transaction were significant in relation to the size and scope of O's activities that further exempt purposes, the transaction with Company K was a one-time occurrence. By adopting a conflicts of interest policy and significant new contract review procedures and by terminating C, O has implemented safeguards that are reasonably calculated to prevent future violations. Moreover, O took corrective actions before the IRS commenced an examination of O. In addition, O has made a good faith effort to seek

correction from Company K, the disqualified person who benefited from the excess benefit transaction. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

Example 5. (i) O is a large organization with substantial assets and revenues. O conducts activities that further exempt purposes. O employs C as its Chief Financial Officer. During Year 1, O pays \$2,500 of C's personal expenses. O does not make these payments under an accountable plan under §53.4958-4(a)(4) of this chapter. In addition, O does not report any of these payments on C's Form W-2, "Wage and Tax Statement," or on a Form 1099-MISC, "Miscellaneous Income," for C for Year 1, and O does not report these payments as compensation on its Form 990, "Return of Organization Exempt From Income Tax," for Year 1. Moreover, none of these payments can be disregarded under section 4958 as nontaxable fringe benefits and none consisted of fixed payments under an initial contract under §53.4958-4(a)(3) of this chapter. C does not report the \$2,500 of payments as income on his individual federal income tax return for Year 1. O does not repeat this reporting omission in subsequent years and, instead, reports all payments of C's personal expenses not made under an accountable plan as income to C.

(ii) O's payment in Year 1 of \$2,500 of C's personal expenses constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, this transaction is subject to the appropriate excise taxes provided in that section. In addition, this transaction violates the proscription against inurement in section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. O engages in regular and ongoing activities that further exempt purposes. The payment of \$2,500 of C's personal expenses represented only a *de minimis* portion of O's assets and revenues; thus, the size and scope of the excess benefit transaction were not significant in relation to the size and scope of O's activities that further exempt purposes. The reporting omission that resulted in the excess benefit transaction in Year 1 is not repeated in subsequent years. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

(3) *Effective date.* The rules in paragraph (g) of this section will apply with respect to excess benefit transactions occurring after the date of publication in the **Federal Register** of a Treasury Decision adopting these rules as final regulations.

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

Par. 4. The authority citation for part 53 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §53.4958-2, paragraph (a)(6) is added to read as follows:

§53.4958-2 Definition of applicable tax-exempt organization.

(a) * * *

(6) *Examples.* The following examples illustrate the principles of this section, which defines an applicable tax-exempt organization for purposes of section 4958:

Example 1. O is a nonprofit corporation formed under state law. O filed its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). In its application, O described its plans for purchasing property from some of its directors at prices that would exceed fair market value. After reviewing the application, the IRS determined that because of the proposed property purchase transactions, O failed to establish that it met the requirements for an organization described in section 501(c)(3). Accordingly, the IRS denied O's application. While O's application was pending, O engaged in the purchase transactions described in its application at prices that exceeded the fair market value of the property. Although these transactions would constitute excess benefit transactions under section 4958, because the IRS never recognized O as an organization described in section 501(c)(3), O was never an applicable tax-exempt organization under section 4958. Therefore, these transactions are not subject to the excise taxes provided in section 4958.

Example 2. O is a nonprofit corporation formed under state law. O files its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). The IRS issues a favorable determination letter in Year 1 that recognizes O as an organization described in section 501(c)(3). Subsequently, in Year 5 of O's operations, O engages in certain transactions that constitute excess benefit transactions under section 4958 and violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2). The IRS examines the Form 990, "Return of Organization Exempt From Income Tax", that O filed for Year 5. After considering all the relevant facts and circumstances in accordance with §1.501(c)(3)-1(g), the IRS concludes that O is no longer described in section 501(c)(3) effective in Year 5. The IRS does not examine the Forms 990 that O filed for its first four years of operations and, accordingly, does not revoke O's exempt status for those years. Although O's tax-exempt status is revoked effective in Year 5, under the look-back rules in §53.4958-2(a)(1) and §53.4958-3(a)(1) of this chapter, for a period of five years prior to the excess benefit transactions that occurred in Year 5, O was an applicable tax-exempt organization and O's directors were disqualified persons as to O. Therefore, the transactions between O and its directors during Year 5 are subject to the appropriate excise taxes provided in section 4958.

* * * * *

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

(Filed by the Office of the Federal Register on September 8, 2005, 8:45 a.m., and published in the issue of the Federal Register for September 9, 2005, 70 F.R. 53599)

Section 1446 Regulations; Withholding on Effectively-Connected Taxable Income Allocable to Foreign Partners; Hearing

Announcement 2005-74

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Change of date of public hearing.

SUMMARY: This document changes the date of a public hearing on proposed regulations (REG-108524-00) relating to the circumstances under which a partnership may take partner-level deductions and losses into account in computing its withholding tax obligation with respect to a foreign partner's allocable share of effectively connected taxable income.

DATES: The public hearing originally scheduled for Monday, October 3, 2005, at 10 a.m. is rescheduled for Wednesday, November 16, 2005, at 10 a.m. Outlines of topics to be discussed at the public hearing were due by September 12, 2005.

ADDRESSES: The public hearing is being held in the IRS auditorium, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance.

FOR FURTHER INFORMATION CONTACT: Richard A. Hurst, (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

A notice of proposed rulemaking (REG-108524-00, 2005-23 I.R.B. 1209) and notice of public hearing appearing in the **Federal Register** on Wednesday, May 18, 2005 (70 FR 28743), announced that a public hearing on proposed regulations relating to circumstances under which a partnership may take partner-level deductions and losses into account in computing its withholding tax obligation with respect to a foreign partner's allocable share of effectively connected taxable income would

be held on Monday, October 3, 2005, beginning at 10 a.m. in the IRS auditorium, 1111 Constitution Avenue, NW, Washington, DC.

The date of the hearing has changed. The hearing is scheduled for Wednesday, November 16, 2005, beginning at 10 a.m. in the IRS auditorium, 1111 Constitution Avenue, NW, Washington, DC. Because of the controlled access restrictions, attendants will not be admitted beyond the lobby area of the Internal Revenue Building until 9:30 a.m. The IRS will prepare an agenda showing the scheduling of the speakers after the outlines are received from the persons testifying and make copies available free of charge at the hearing.

Cynthia Grigsby,
Acting Chief, Publications and
Regulations Branch,
Legal Processing Division,
Associate Chief Counsel
(Procedure and Administration).

(Filed by the Office of the Federal Register on September 30, 2005, 8:45 a.m., and published in the issue of the Federal Register for October 3, 2005, 70 F.R. 57523)

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

Announcement 2005-75

The names of organizations that no longer qualify as organizations described in section 170(c)(2) of the Internal Revenue Code of 1986 are listed below.

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

activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on October 17, 2005, 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.

Alpha Kappa Psi Scholarship Fund
Minneapolis, MN

Alphabets Childcare Center, Inc.
Clarksville, TN

Inner City Development Foundation
Los Angeles, CA

Rocky Road Incorporated
Snowmass Village, CO

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

Announcement 2005-76

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
Reagan, John	Cortland, NY	CPA	Indefinite from June 24, 2005
Harris, Alexander W.	Chicago, IL	Attorney	July 1, 2005 to December 31, 2005

Name	Address	Designation	Date of Suspension
Belush, Glen J.	Monroe, CT	CPA	Indefinite from July 15, 2005
Lamont, Alice	Atlanta, GA	CPA	Indefinite from July 15, 2005
Morse, Kyle K.	Bedford, TX	CPA	Indefinite from July 22, 2005
Duggan Jr., Joseph A.	Jacksonville, OR	Enrolled Agent	Indefinite from August 1, 2005
Harper, Ivan	Brooklyn, NY	CPA	Indefinite from August 15, 2005
Bandy, Robert M.	Tyler, TX	Attorney	Indefinite from August 24, 2005
Peterson, Stanley	Springfield, PA	CPA	Indefinite from August 26, 2005
Shorten, Judy	Vacaville, CA	Enrolled Agent	Indefinite from September 1, 2005
Watkins, David E.	Shelbyville, IN	Enrolled Agent	Indefinite from September 1, 2005

Expedited Suspensions From Practice Before the Internal Revenue Service

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

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

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

Name	Address	Designation	Date of Suspension
Leong, Thomas S.	Honolulu, HI	Attorney	Indefinite from July 11, 2005
Clark, Mark S.	Tucson, AZ	Attorney	Indefinite from July 11, 2005

Name	Address	Designation	Date of Suspension
Hudspeth, George E.	St. Louis, MO	Attorney	Indefinite from July 11, 2005
Dodd, Alan F.	Westborough, MA	Attorney	Indefinite from July 11, 2005
Crews, James F.	Tipton, MO	Attorney	Indefinite from July 11, 2005
Luparella, Joseph	Hoboken, NJ	CPA	Indefinite from July 13, 2005
Deutchman, Murray	Barnesville, MD	Attorney	Indefinite from July 13, 2005
Cozier, Clifford G.	Englewood, CO	Attorney	Indefinite from July 13, 2005
Segall, Steven M.	Denver, CO	Attorney	Indefinite from July 14, 2005
Richardson, Bruce	Reisterstown, MD	Attorney	Indefinite from July 15, 2005
Parsley, Jeffrey A.	Englewood, CO	Attorney	Indefinite from July 15, 2005
Wyrick, Richard L.	Hanford, CA	Attorney	Indefinite from July 15, 2005
Coates, Marsden S.	Baltimore, MD	Attorney	Indefinite from July 15, 2005
McCampbell, Daniel	Chico, CA	Attorney	Indefinite from July 15, 2005
Ralston, Ronald G.	Fairmount, GA	CPA	Indefinite from July 18, 2005
Friemann, Robert F.	Huntington Bay, NY	CPA	Indefinite from July 18, 2005
Friedman, Milton G.	Ft. Lauderdale, FL	CPA	July 25, 2005 to January 24, 2007

Name	Address	Designation	Date of Suspension
Acheampong, Robert	Columbus, OH	CPA	Indefinite from July 26, 2005
Elias, Robert F.	Canfield, OH	Attorney	Indefinite from July 27, 2005
Stover, Kathy A.	Topeka, KS	Attorney	Indefinite from July 29, 2005
Leffler, Fredric D.	Columbia, MD	Attorney	Indefinite from July 29, 2005
Harmon, Anthony N.	Batavia, IL	Attorney	Indefinite from July 29, 2005
Hames, David H.	Dallas, TX	CPA	Indefinite from August 2, 2005
Au, Ronald G.S.	Honolulu, HI	Attorney	Indefinite from August 9, 2005
Tilton Jr., George H.	Denver, CO	Attorney	Indefinite from August 12, 2005
Spalsbury Jr., Clark	Estes Park, CO	Attorney	Indefinite from August 12, 2005
Brockman, Louis R.	Dallas, TX	CPA	Indefinite from August 12, 2005
Hill, Richard B.	Kernersville, NC	CPA	Indefinite from August 12, 2005
Rosenberg, Jeffrey P.	Morgan Hill, CA	Attorney	Indefinite from August 12, 2005
Link, Robert A.	Waupaca, WI	CPA	Indefinite from August 15, 2005
Halcrow, David S.	Taft, CA	CPA	Indefinite from September 9, 2005
Lieber, Daniel M.	Edna, MO	Attorney	Indefinite from September 9, 2005
Kirchoff, William W.	Jefferson City, MO	Attorney	Indefinite from September 9, 2005

Name	Address	Designation	Date of Suspension
Lauby, Gregory C.	Lexington, NE	Attorney	Indefinite from September 9, 2005
Early, Michael J.	Newburyport, MA	Attorney	Indefinite from September 9, 2005
Mickiewicz, Robert	Dorchester, MA	Attorney	Indefinite from September 9, 2005
Conant, Jon F.	Gloucester, MA	Attorney	Indefinite from September 9, 2005
Pennington, Jill	Chevy Chase, MD	Attorney	Indefinite from September 9, 2005
Randolph, Robert E.	Denham Springs, LA	Attorney	Indefinite from September 9, 2005
Carillo, Donald	Chicago, IL	Attorney	Indefinite from September 9, 2005
Sloan Jr., Dewey	Sioux City, IA	Attorney	Indefinite from September 9, 2005
Vogel, Garrett	Dallas, TX	CPA	Indefinite from September 13, 2005
Becker, Joseph	Houston, TX	CPA	Indefinite from September 13, 2005
Winick, Robert M.	Sarasota, FL	Attorney	Indefinite from September 19, 2005
Hunsaker Jr., William	Golden, CO	Attorney	Indefinite from September 19, 2005
Wheatley, Jay D.	Boca Raton, FL	Attorney	Indefinite from September 19, 2005
Clark, Carroll A.	Mesa, AZ	Attorney	Indefinite from September 19, 2005

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

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

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

from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Sobel, Herbert L.	Elkins Park, PA	CPA	May 4, 2005 to February 3, 2007
Rubesh, Leland	Gillette, WY	CPA	August 1, 2005 to January 31, 2007
Gregory, Carolyn S.	Cathedral City, CA	Enrolled Agent	August 12, 2005 to November 11, 2007

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
Pugno, Thomas	Rockwood, MI	Enrolled Agent	June 29, 2005
Barrett, Richard	Tyler, TX	CPA	August 1, 2005
Kelly, Michael G.	Odessa, TX	Attorney	August 1, 2005
Volstad, Paul S.	Plymouth, MN	CPA	August 18, 2005
Quackenbush, Gary A.	San Diego, CA	Attorney	September 2, 2005
Flores, Fred A.	Laredo, TX	CPA	September 2, 2005
Velasquez, Felix	Laredo, TX	CPA	September 2, 2005

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.

ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.

PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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¹ A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2005–1 through 2005–26 is in Internal Revenue Bulletin 2005–26, dated June 27, 2005.

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¹ A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2005–1 through 2005–26 is in Internal Revenue Bulletin 2005–26, dated June 27, 2005.

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