

## **HIGHLIGHTS OF THIS ISSUE**

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

### **INCOME TAX**

#### **Rev. Rul. 2007-7, page 468.**

**Investor control and general public; taxation of variable contracts; insurance and annuities.** This ruling effectively excludes classes of beneficial ownership from the definition of "general public" as defined in Rev. Rul. 81-225, 1981-2 C.B. 12, for purposes of investor control analysis. Investor control analysis is used to determine who owns (and is taxed on) income generated inside of variable contracts (e.g., variable life insurance contracts or variable annuity contracts). Rev. Ruls. 81-225 and 2003-92 clarified and amplified.

#### **Rev. Rul. 2007-8, page 469.**

**Section 357(c).** Section 357(c)(1) of the Code does not apply to transactions that qualify as reorganizations described in sections 368(a)(1)(A), (C), (D), or (G), and to which section 351 applies, provided certain requirements are satisfied. Rev. Ruls. 75-161 and 76-188 obsoleted. Rev. Rul. 78-330 modified.

#### **T.D. 9305, page 479.**

Final regulations under section 863 of the Code contain rules governing the source of income from certain space and ocean activities. They also contain rules 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). The regulations also affect persons who derive income from transmission of communications.

#### **T.D. 9307, page 470.**

Final regulations under sections 446(e) and 1016(a)(2) of the Code provide rules for determining which changes in depreciation or amortization are, and are not, changes in method of accounting.

#### **T.D. 9309, page 497.**

Final regulations under section 6664 of the Code provide circumstances that end the period within which a taxpayer may file an amended return that constitutes a qualified amended return. Qualified amended returns are used to determine whether an underpayment exists that is potentially subject to the accuracy-related penalty on underpayments.

#### **Rev. Proc. 2007-20, page 517.**

This procedure provides exceptions to the contractual protection filter, which is a reportable transaction under regulations section 1.6011-4(b)(4). Rev. Proc. 2004-65 modified and superseded.

### **EMPLOYEE PLANS**

#### **Notice 2007-14, page 501.**

**Permitted benefits; defined benefit plan.** This notice, which is a notice of intent to propose regulations, requests comments regarding the types of benefits permitted to be provided in a qualified defined benefit plan.

(Continued on the next page)

Finding Lists begin on page ii.

## EXEMPT ORGANIZATIONS

### **Announcement 2007–13, page 519.**

The IRS has revoked its determination that Hawaii Credit Counseling Service of Honolulu, HI; and Lighthouse Credit Foundation, Inc., of Largo, FL, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

### **Announcement 2007–14, page 519.**

A list is provided of organizations now classified as private foundations.

## ADMINISTRATIVE

### **Notice 2007–15, page 503.**

**Insurance companies; closing agreements.** This notice requests comments on how the Service may improve the procedures for obtaining closing agreements to correct inadvertent failures of life insurance contracts or annuity contracts to satisfy the requirements of sections 817(h), 7702, or 7702A. The Service is also asking for comments on the four model closing agreements provided in this notice.

### **Rev. Proc. 2007–19, page 515.**

**Insurance companies; modified endowment contracts.** This procedure modifies Rev. Proc. 2001–42, 2001–2 C.B. 212, which provides procedures by which an issuer may remedy an in-advertent non-egregious failure to comply with the modified endowment contract (MEC) rules under section 7702A of the Code. The procedure updates information regarding the indices referenced in Rev. Proc. 2001–42 and also changes one of the indices. It allows the electronic submission of information and templates and changes the address to which payments required under the closing agreement are sent. Rev. Proc. 2001–42 modified and amplified.

### **Announcement 2007–4, page 518.**

This document contains corrections to proposed regulations (REG–208270–86, 2006–42 I.R.B. 698) regarding the determination of the items of income or loss of a taxpayer with respect to a section 987 of the Code qualified business unit as well as the timing, amount character, and source of any section 987 gain or loss.

### **Announcement 2007–19, page 521.**

This document cancels a public hearing on proposed regulations (REG–136806–06, 2006–47 I.R.B. 950) modifying the standards for treating payments in lieu of taxes (PILOTs) as generally applicable taxes for purposes of the private security or payment test under section 141 of the Code.

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## Introduction

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

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

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

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

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

### **Part II.—Treaties and Tax Legislation.**

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

### **Part III.—Administrative, Procedural, and Miscellaneous.**

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

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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

## Section 61.—Gross Income Defined

26 CFR 1.61-1: Gross income.  
(Also § 817; § 1.817-5.)

**Investor control and general public; taxation of variable contracts; insurance and annuities.** This ruling effectively excludes classes of beneficial ownership from the definition of “general public” as defined in Rev. Rul. 81-225, 1981-2 C.B. 12, for purposes of investor control analysis. Investor control analysis is used to determine who owns (and is taxed on) income generated inside of variable contracts (e.g., variable life insurance contracts or variable annuity contracts). Rev. Ruls. 81-225 and 2003-92 clarified and amplified.

### Rev. Rul. 2007-7

#### ISSUE

Is the holder of a variable annuity or life insurance contract treated as the owner, for federal income tax purposes, of an interest in a regulated investment company that funds the variable contract solely because interests in the same regulated investment company are also available to investors described in § 1.817-5(f)(3) of the Income Tax Regulations?

#### FACTS

A, an individual, purchases a variable contract (within the meaning of § 817(d) of the Internal Revenue Code) from IC, a life insurance company subject to tax under Part 1 of Subchapter L. All assets funding the contract are held in a segregated asset account that invests in RIC, a regulated investment company. All the beneficial interests in RIC are held by one or more segregated asset accounts of IC, or by investors described in § 1.817-5(f)(3). Public access to RIC is available exclusively either through the purchase of a variable contract, or to investors described in § 1.817-5(f)(3).

#### LAW AND ANALYSIS

In Rev. Rul. 2003-92, 2003-2 C.B. 350, a taxpayer purchased a variable “annuity” contract. The segregated asset account on which the contract was based was divided into 10 sub-accounts, each of which invested in a partnership. Interests in each partnership were sold in private placement offerings to qualified purchasers. The ruling concludes that, because interests in the partnerships were available for purchase by the general public, the taxpayer is considered the owner for federal tax purposes of the interests in the partnerships held by the sub-accounts. The same analysis applies in the case of a variable life insurance contract. Rev. Rul. 2003-92 clarified and amplified Rev. Rul. 81-225, 1981-2 C.B. 12, which concluded that the policyholder is considered the owner of mutual fund shares that fund a variable “annuity” contract where those shares are also available directly or indirectly to the general public.

Section 817(h) and § 1.817-5 set forth diversification requirements for segregated asset accounts on which variable contracts are based. Section 817(h)(4) and § 1.817-5(f) provide a look-through rule for determining whether those diversification requirements are met. The look-through rule applies to a regulated investment company, partnership, or trust, but only if (A) all the beneficial interests in the investment company, partnership, or trust are held by one or more segregated asset accounts of one or more insurance companies, and (B) public access to the investment company, partnership or trust is available exclusively through the purchase of a variable contract. Under § 1.817-5(f)(3), the following four categories of beneficial interest are ignored for purposes of determining whether these two requirements are satisfied:

(1) Interests held by the general account of a life insurance company or a corporation related to a life insurance company, but only if the return on such interests is computed in the same manner as the return on an interest held by a segregated asset account is computed, there is no intent to sell such interests to the public, and a segre-

gated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company, partnership, or trust;

(2) Interests held by a manager, or a corporation related to the manager, of the investment company, partnership or trust, but only if the holding of the interests is in connection with the creation or management of the investment company, partnership or trust, the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed, and there is no intent to sell such interests to the public;

(3) Interests held by the trustee of a qualified pension or retirement plan; or

(4) Interests held by the public, or treated as owned by the policyholders pursuant to Rev. Rul. 81-225, but only if (A) the investment company, partnership or trust was closed to the public in accordance with Rev. Rul. 82-55, 1982-1 C.B. 12, or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders before September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

The investors described in § 1.817-5(f)(3) are not members of the “general public” as that term is used in Rev. Rul. 2003-92 and Rev. Rul. 81-225. In the present case, all the beneficial interests in RIC are held by one or more segregated asset accounts of IC, or by investors described in § 1.817-5(f)(3), and public access to RIC is available exclusively either through the purchase of a variable contract, or to investors described in § 1.817-5(f)(3). Accordingly, interests in RIC are not available to the “general public” as that term is used in Rev. Rul. 2003-92 and Rev. Rul. 81-225, and A is not treated as the owner of an interest in a regulated investment company that funds the variable contract.

#### HOLDING

The holder of a variable annuity or life insurance contract is not treated as the owner of an interest in a regulated

investment company that funds the variable contract solely because interests in the same regulated investment company are also available to investors described in § 1.817-5(f)(3).

#### EFFECT ON OTHER REVENUE RULING(S)

Rev. Rul. 81-225, 1981-2 C.B. 12, and Rev. Rul. 2003-92, 2003-2 C.B. 350, are hereby clarified and amplified.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Chris Lieu of the Office of Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Chris Lieu at (202) 622-3970 (not a toll-free call).

## Section 357.—Assumption of Liability

26 CFR 1.357-2: *Liabilities in excess of basis.*

**Section 357(c).** Section 357(c)(1) of the Code does not apply to transactions that qualify as reorganizations described in sections 368(a)(1)(A), (C), (D), or (G), and to which section 351 applies, provided certain requirements are satisfied. Rev. Ruls. 75-161 and 76-188 obsoleted. Rev. Rul. 78-330 modified.

### Rev. Rul. 2007-8

#### ISSUE

Does § 357(c)(1) of the Internal Revenue Code apply to transactions that qualify as reorganizations described in §§ 368(a)(1)(A), (C), (D) (provided the requirements of § 354(b)(1) are satisfied), or (G) (provided the requirements of § 354(b)(1) are satisfied) and to which § 351 applies?

#### FACTS

*Situation 1.* A, an individual, owned all of the stock of corporation X and corporation Y. Y acquired all of the assets of X in exchange for an amount of Y stock constituting § 368(c) control and the assumption by Y of X's liabilities. Pursuant to the plan, X liquidated and distributed

the Y stock to A. At the time of the acquisition, the sum of the X liabilities assumed by Y exceeded X's total adjusted basis in the property transferred to Y. Further, the value of X's assets transferred to Y exceeded the amount of X's liabilities assumed by Y, and, immediately after the exchange, the value of Y's assets exceeded the amount of Y's liabilities. The transaction qualified as a reorganization described in § 368(a)(1)(D) and as an exchange to which § 351 applied.

*Situation 2.* A, an individual, owned all of the stock of corporation X. B, an individual unrelated to A, owned all of the stock of corporation Y. Y acquired all of the assets of X in exchange for Y voting stock and the assumption by Y of X's liabilities. Pursuant to the plan, X liquidated and distributed the Y voting stock to A. At the time of the acquisition, the sum of the X liabilities assumed by Y exceeded X's total adjusted basis in the property transferred to Y. Further, the value of X's assets transferred to Y exceeded the amount of X's liabilities assumed by Y, and, immediately after the exchange, the value of Y's assets exceeded the amount of Y's liabilities. Simultaneously, and as part of the overall plan, B contributed property to Y in exchange for additional Y stock so that immediately after the transaction, B held more than 50 percent of the vote and of the value of all the stock of Y. The Y stock issued to X along with the Y stock issued to and held by B immediately after the transaction constituted § 368(c) control of Y. The transfer by X of all of its assets to Y in exchange for Y voting stock and assumption of liabilities, followed by the liquidation of X, qualified as a reorganization described in § 368(a)(1)(C). Further, X's transfer of assets to Y in exchange for Y voting stock along with B's transfer of property to Y in exchange for additional Y stock was an exchange to which § 351 applied.

#### LAW AND ANALYSIS

Section 357(a) provides that if, as part of the consideration in an exchange to which § 351 or § 361 applies, a liability of the taxpayer is assumed by another party to the exchange then such assumption shall not be treated as money or other property. However, in the case of certain exchanges, § 357(c)(1) provides that the transferor is

required to recognize gain if the sum of the amount of liabilities assumed exceeds the total of the adjusted basis of the property transferred. Prior to the enactment of The American Jobs Creation Act of 2004 (Public Law 108-357, 188 Stat. 1418) (the Jobs Act), § 357(c)(1) applied in the case of an exchange (A) to which § 351 applied, or (B) to which § 361 applied by reason of a plan of reorganization within the meaning of § 368(a)(1)(D). The Jobs Act amended § 357(c)(1)(B), limiting the application of § 357(c)(1) to exchanges to which § 351 applies, or to which § 361 applies by reason of a plan of reorganization within the meaning of § 368(a)(1)(D) with respect to which stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under § 355. Thus, as amended, § 357(c) no longer applies to an acquisitive § 368(a)(1)(D) reorganization — *i.e.*, one that satisfies the requirements of § 354(b)(1).

The legislative history to the Jobs Act amendment to § 357(c)(1)(B) explains Congress's intent in removing acquisitive § 368(a)(1)(D) reorganizations from the application of § 357(c)(1), as follows:

The Committee believes that . . . the [transferee] should be permitted to assume liabilities of the [transferor] without application of the rule of section 357(c). This is because in an acquisitive reorganization under section 368(a)(1)(D), the transferor must generally transfer substantially all of its assets to the acquiring corporation and then go out of existence. Assumption of its liabilities by the acquiring corporation thus does not enrich the transferor corporation, which ceases to exist, and whose liability was limited to its assets in any event, by corporate form. The Committee believes that it was appropriate to conform the treatment of acquisitive reorganizations under section 368(a)(1)(D) to that of other acquisitive reorganizations.

S. Rep. No. 192, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. 185 (2003).

The Jobs Act amendment to § 357(c)(1)(B) excluded acquisitive § 368(a)(1)(D) reorganizations from the application of § 357(c)(1), because in such transactions the transferor ceases to exist and cannot be enriched by the assumption of its liabilities. The Jobs Act

legislative history states that the amendment was made to conform the treatment of § 368(a)(1)(D) acquisitive reorganizations to the treatment of other acquisitive reorganizations. Therefore, the intent of the Jobs Act amendment to § 357(c)(1)(B) was to exclude reorganizations from the application of § 357(c)(1) unless described in § 357(c)(1)(B), regardless of whether such reorganizations are also exchanges to which § 351 applies.

In the transactions set forth in both Situation 1 and Situation 2, the transferor corporation ceases to exist and, therefore, cannot be enriched as a result of the assumption of its liabilities. In accordance with the above reasoning, in both Situation 1 and Situation 2, § 357(c)(1) does not apply to X's transfer of assets to Y in exchange for Y stock and assumption of X's liabilities notwithstanding the fact that such transfers were also exchanges to which § 351 applied.

In addition, under § 368(a)(3)(C), if a reorganization qualifies under § 368(a)(1)(G) and under any other subparagraph of § 368(a)(1) or under § 332 or § 351, then, other than for purposes of § 357(c)(1), the transaction will be treated as qualifying only under § 368(a)(1)(G). However, because § 357(c)(1) is no longer applicable to a transaction that qualifies as a reorganization described in § 368(a)(1)(A), (C), or (D) (provided the requirements of § 354(b)(1) are satisfied), it is also no longer applicable to a reorganization described in § 368(a)(1)(G) (provided the requirements of § 354(b)(1) are satisfied), regardless of whether § 351 applies.

#### HOLDING

Section 357(c)(1) does not apply to transactions that qualify as reorganizations described in §§ 368(a)(1)(A), (C), (D) (provided the requirements of § 354(b)(1) are satisfied), or (G) (provided the requirements of § 354(b)(1) are satisfied) and to which § 351 applies.

#### EFFECT ON OTHER REVENUE RULING

Rev. Rul. 75-161, 1975-1 C.B. 114, and Rev. Rul. 76-188, 1976-1 C.B. 99, are obsolete. Rev. Rul. 78-330, 1978-2 C.B. 147, is modified to the extent it holds that § 357(c)(1) is applicable to a transac-

tion that qualifies as a reorganization described in § 368(a)(1)(A) or (D) (that satisfies the requirements of § 354(b)(1)).

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Rebecca O. Burch of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Rebecca O. Burch at (202) 622-7550 (not a toll-free call).

## Section 446.—General Rule for Methods of Accounting

*26 CFR 1.446-1: General rule for methods of accounting.*

### T.D. 9307

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

### Changes in Computing Depreciation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to a change in computing depreciation or amortization as well as a change from a nondepreciable or non-amortizable asset to a depreciable or amortizable asset (or *vice versa*). Specifically, these regulations provide guidance to any taxpayer that makes a change in depreciation or amortization on whether such a change is a change in method of accounting under section 446(e) of the Internal Revenue Code and on the application of section 1016(a)(2) in determining whether the change is a change in method of accounting.

DATES: *Effective Date:* These regulations are effective December 28, 2006.

*Applicability Dates:* For dates of applicability, see §§1.167(e)-1(e), 1.446-1(e)(4), and 1.1016-3(j).

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

#### SUPPLEMENTARY INFORMATION:

#### Background

This document contains amendments to 26 CFR part 1. On January 2, 2004, the IRS and Treasury Department published temporary regulations (T.D. 9105, 2004-1 C.B. 419) in the **Federal Register** (69 FR 5) relating to the application of section 446(e) of the Internal Revenue Code (Code) and §1.167(e)-1 to a change in depreciation or amortization and the application of section 1016(a)(2) in determining whether a change in depreciation or amortization is a change in method of accounting. On the same date, the IRS published a notice of proposed rulemaking (REG-126459-03, 2004-1 C.B. 437) cross-referencing the temporary regulations in the **Federal Register** (69 FR 42). No public hearing was requested or held. Several comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The revisions are discussed here in this preamble.

Section 1400N(d), which was added to the Code by section 101(a) of the Gulf Opportunity Zone Act of 2005, Public Law 109-135 (119 Stat. 2577), generally allows a 50-percent additional first year depreciation deduction for qualified Gulf Opportunity Zone property. The final regulations reflect the enactment of section 1400N(d).

#### Explanation of Provisions

##### Scope

The final regulations provide the changes in depreciation or amortization (depreciation) for property for which depreciation is determined under section 167, 168, 197, 1400I, 1400L(b), 1400L(c), or 1400N(d), or former section 168, of the Code that are, and those changes that are not, changes in method of accounting under section 446(e). The final regulations also clarify that the rules in §1.167(e)-1 with respect to a change in the deprecia-

tion method made without the consent of the Commissioner apply only to property for which depreciation is determined under section 167 (other than under section 168, 1400I, 1400L, or 1400N(d), or former section 168). Additionally, the final regulations provide that section 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation is a change in method of accounting under section 446(e) and §1.446-1(e).

### *I. Changes in Depreciation Method under Section 167*

The final regulations retain the rules contained in the temporary regulations providing that the rules in §1.167(e)-1 with respect to a change in depreciation method under §1.167(e)-1(b), (c), and (d) made without the consent of the Commissioner apply only to property for which depreciation is determined under section 167 (other than under section 168, 1400I, 1400L, or 1400N(d), or former section 168). No comments were received suggesting changes to these rules.

### *II. Changes in Depreciation That Are, and Are Not, a Change in Method of Accounting Under Section 446(e)*

The final regulations provide rules on the changes in depreciation that are, and are not, a change in method of accounting under section 446(e).

#### *A. Changes in Depreciation That Are Changes in Method of Accounting*

The final regulations retain the rules contained in the temporary regulations providing the changes in depreciation that are a change in method of accounting under section 446(e). These changes are a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or *vice versa*. Additionally, a correction to require depreciation in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or *vice versa*, is a change in method of accounting. Further, changes in computing depreciation generally are a change in method of accounting, including a change in the depreciation method, period of recovery, or convention

of a depreciable or amortizable asset, and a change to or from claiming the additional first year depreciation deduction provided by section 168(k), 1400L(b), or 1400N(d) under certain circumstances.

No comments were received suggesting changes to these rules. However, a commentator inquired whether a calendar-year taxpayer that has not claimed the 30-percent additional first year depreciation for qualified property acquired after September 10, 2001, and placed in service prior to January 1, 2002, may claim the 30-percent additional first year depreciation by requesting a change in method of accounting. To claim the 30-percent additional first year depreciation for this property, Rev. Proc. 2003-50, 2003-2 C.B. 119, provides that the taxpayer had to file an amended return on or before December 31, 2003, or file a Form 3115, "*Application for Change in Accounting Method*," with the taxpayer's timely filed 2003 Federal tax return. If the taxpayer did not file this amended return or Form 3115, the taxpayer has made the deemed election not to deduct the additional first year depreciation for the 2001 taxable year. Accordingly, the taxpayer's change to claiming the 30-percent additional first year depreciation for qualified property placed in service in the taxable year that included September 11, 2001, is not a change in method of accounting under the temporary and final regulations. Instead, the taxpayer must file a request for a letter ruling to revoke the election.

Another commentator questioned whether the temporary regulations affected the procedures for obtaining consent to make a change in method of accounting. The regulations did not change these procedures and, accordingly, the rules in §1.446-1(e)(3) apply to a change in depreciation that is a change in method of accounting. Other commentators inquired whether a change in depreciation due to a posting or mathematical error, or a change in underlying facts, is a change in method of accounting. A change in depreciation due to a posting or mathematical error, or a change in underlying facts, is not a change in method of accounting because the rules in §1.446-1(e)(2)(ii)(a) and (b) also apply to a change in depreciation. Accordingly, the final regulations clarify this point.

#### *B. Changes in Depreciation That Are Not Changes in Method of Accounting*

The final regulations retain the rule contained in the temporary regulations that a change in method of accounting does not include an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, 1400I, 1400L, or 1400N(d), or former section 168). This rule does not apply, however, if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin. Several commentators questioned whether the useful life exception from change in method of accounting treatment that was in effect before the issuance of the temporary regulations has any remaining application. Section 1.446-1(e)(2)(ii)(b), as in effect before the issuance of the temporary regulations (see §1.446-1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003), provided that a change in the method of accounting does not include an adjustment in the useful life of a depreciable asset. The rule still applies but is limited by the temporary and final regulations to only a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, 1400I, 1400L, or 1400N(d), or former section 168) and to only an adjustment in useful life that is not specifically assigned by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin.

The final regulations also retain the rules contained in the temporary regulations of when an adjustment in useful life that is not a change in method of accounting is implemented. The final regulations clarify that these rules apply regardless of whether the adjustment in useful life is initiated by the IRS or a taxpayer. Furthermore, the final regulations clarify that in implementing an adjustment in useful life that is not a change in method of accounting, no section 481 adjustment is required or permitted.

The final regulations retain the rule contained in the temporary regulations providing that the making of a late depreciation election or the revocation of a timely valid



depreciation election is not a change in method of accounting, except as otherwise provided by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin. A commentator inquired whether a late section 179 election may be made by requesting a change in method of accounting. Under section 179 and the regulations under section 179, a late section 179 election generally is made by submitting a request for a letter ruling. However, for a taxable year beginning after 2002 and before 2010, a taxpayer may make a section 179 election by filing an amended return. Accordingly, the IRS and Treasury Department have included a cross-reference to section 179(c) and §1.179-5.

The final regulations retain the rule contained in the temporary regulations providing that any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. The final regulations, however, clarify that this rule does not apply when the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, provide that a change in placed-in-service date is treated as a change in method of accounting. A commentator requested that the final regulations clarify what constitutes a change in placed-in-service date. To illustrate the rule, the IRS and Treasury Department provided additional clarification in the final regulations. For example, the final regulations provide that if a taxpayer changes the placed-in-service date of a depreciable or amortizable asset because the taxpayer incorrectly determined the date on which the asset was placed in service, this change is not a change in method of accounting. However, if a taxpayer incorrectly determines that a depreciable or amortizable asset is nondepreciable property and later changes the treatment of the asset to depreciable property, this change is not a change in the placed-in-service date of the asset but is a change from nondepreciable to depreciable property and, therefore, the change is a change in method of accounting. The final regulations also clarify that a change in the convention of a depreciable or amortizable asset is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting. Additionally, the final regulations provide examples illustrating what

constitutes a change in placed-in-service date.

The final regulations retain the rules contained in the temporary regulations as to how and when a change in placed-in-service date that is not a change in method of accounting is implemented. The final regulations also clarify that these rules apply regardless of whether the change in placed-in-service date is made by the IRS or a taxpayer. Finally, the final regulations provide that in implementing a change in placed-in-service date that is not a change in method of accounting, no section 481 adjustment is required or permitted.

### C. Item Being Changed

The final regulations retain the rule contained in the temporary regulations providing that for purposes of a change in depreciation, the item being changed is the depreciation treatment of each individual depreciable or amortizable asset or the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under §1.167(a)-11 (CLADR). Because general asset accounts and mass asset accounts are similar to vintage accounts, the final regulations clarify that the item is the depreciable treatment of each general asset account with respect to a depreciable asset for which general asset account treatment has been elected under section 168(i)(4) or the item is the depreciation treatment of each mass asset account with respect to a depreciable asset for which mass asset account treatment has been elected under former section 168(d)(2)(A). The final regulations also retain the rule contained in the temporary regulations providing that a change in depreciation under section 167 (other than under section 168, 1400I, 1400L, or 1400N(d), or former section 168) is permitted only with respect to all assets in a particular account (as defined in §1.167(a)-7) or vintage account.

### D. Effective Dates

Several commentators questioned the application of the effective date of the temporary regulations. In response, the IRS, in Chief Counsel Notice 2004-007 (CC-2004-007, January 28, 2004) and Chief Counsel Notice 2004-024 (CC-2004-024, July 12, 2004) (see [www.irs.gov/foia](http://www.irs.gov/foia)), clarified that the

temporary regulations apply to property placed in service in a taxable year ending on or after December 30, 2003. In accordance with this clarification, the final regulations apply only to a change in depreciation made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003, regardless of whether or not the change in depreciation is a change in method of accounting. Additionally, the examples in the final regulations relating to a change in depreciation have been revised to reflect this effective date.

### III. Application of Section 1016(a)(2) to a Change in Method of Accounting

The final regulations contain the same rule as the temporary regulations, providing that section 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation for property subject to section 167, 168, 1400I, 1400L, or 1400N(d), or former section 168, is a change in method of accounting under section 446(e) and the regulations under section 446(e). No comments were received suggesting changes to this rule.

### Special Analyses

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

### Drafting Information

The principal author of these regulations is Douglas H. Kim, Office of Associate Chief Counsel (Passthroughs and

Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

## 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 1.167(e)-1 is amended by revising paragraphs (a) and (e) to read as follows:

#### *§1.167(e)-1 Change in method.*

(a) *In general.* (1) Any change in the method of computing the depreciation allowances with respect to a particular account (other than a change in method permitted or required by reason of the operation of former section 167(j)(2) and §1.167(j)-3(c)) is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that certain changes to the straight line method of depreciation will be permitted without consent as provided in former section 167(e)(1), (2), and (3). Except as provided in paragraphs (c) and (d) of this section, a change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in §1.167(a)-7. Any change in the percentage of the current straight line rate under the declining balance method, for example, from 200 percent of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method, will constitute a change in method of depreciation. Any request for a change in method of depreciation shall be made in accordance with section 446(e) and the regulations under section 446(e). For rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions, see section 381(c)(6) and the regulations under section 381(c)(6).

(2) Paragraphs (b), (c), and (d) of this section apply to property for which de-

preciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), under section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121), or under an additional first year depreciation deduction provision (for example, section 168(k), 1400L(b), or 1400N(d))) of the Internal Revenue Code.

\* \* \* \* \*

(e) *Effective date.* This section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.167(e)-1 in effect prior to December 30, 2003 (§1.167(e)-1 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

#### **§1.167(e)-1T [Removed]**

Par. 3. Section 1.167(e)-1T is removed.

Par. 4. Section 1.168(i)-4 is amended as follows:

1. Paragraph (f) is amended by removing the language “§1.446-1T (e)(2)(ii)(d)(3)(ii)” at the end of the paragraph and adding “§1.446-1(e)(2)(ii)(d)(3)(ii)” in its place.

2. Paragraph (g)(2)(ii) is amended by removing the language “as modified by Rev. Proc. 2004-11, 2004-1 C.B. 311.”

Par. 5. Section 1.168(i)-6T is amended as follows:

1. Paragraph (k)(2)(i) is amended by removing the language “§1.446-1T (e)(3)(ii)” and adding “§1.446-1(e)(3)(ii)” in its place.

2. The last sentence in paragraph (k)(2)(ii) is amended by removing the language “§1.446-1T(e)(3)(ii)” and adding “§1.446-1(e)(3)(ii)” in its place.

Par. 6. Section 1.446-1 is amended by revising paragraphs (e)(2)(ii)(a), (e)(2)(ii)(b), (e)(2)(ii)(d), (e)(2)(iii), and (e)(4) to read as follows:

#### *§1.446-1 General rule for methods of accounting.*

\* \* \* \* \*

(e) \* \* \*

(2) \* \* \*

(ii) (a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such over-

all plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or *vice versa*, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or *vice versa* (see §1.460-4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Internal Revenue Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the In-

ternal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(d) of this section and §1.1016-3(h).

\* \* \* \* \*

(d) *Changes involving depreciable or amortizable assets*—(1) *Scope*. This paragraph (e)(2)(ii)(d) applies to property subject to section 167, 168, 197, 1400I, 1400L(c), to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168), or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)).

(2) *Changes in depreciation or amortization that are a change in method of accounting*. Except as provided in paragraph (e)(2)(ii)(d)(3) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or *vice versa*, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or *vice versa*, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(d)(3) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

(i) A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

(ii) A change from not claiming to claiming the additional first year depreciation deduction provided by, for example, section 168(k), 1400L(b), or 1400N(d), for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone prop-

erty, or qualified Gulf Opportunity Zone property), provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a deemed election out of the additional first year depreciation deduction; for further guidance, for example, see Rev. Proc. 2002-33, 2002-1 C.B. 963, Rev. Proc. 2003-50, 2003-2 C.B. 119, Notice 2006-77, 2006-40 I.R.B. 590, and §601.601(d)(2)(ii)(b) of this chapter) for the class of property in which the depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property) is included.

(iii) A change from claiming the 30-percent additional first year depreciation deduction to claiming the 50-percent additional first year depreciation deduction for depreciable property that qualifies for the 50-percent additional first year depreciation deduction, provided the property is not included in any class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction (for example, 50-percent bonus depreciation property or qualified Gulf Opportunity Zone property), or a change from claiming the 50-percent additional first year depreciation deduction to claiming the 30-percent additional first year depreciation deduction for depreciable property that qualifies for the 30-percent additional first year depreciation deduction, including property that is included in a class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction (for example, qualified property or qualified New York Liberty Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(d)(2)(iii) does not apply if a taxpayer is making a late election or revoking a timely valid election under the applicable additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) (see paragraph (e)(2)(ii)(d)(3)(iii) of this section).

(iv) A change from claiming to not claiming the additional first year depreciation deduction for an asset that does not qualify for the additional first year depreciation deduction, including an asset that is included in a class of property for which the taxpayer elected not to claim any additional first year depreciation deduction (for example, an asset that is not qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's depreciable basis.

(v) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4)), the regulations under the Internal Revenue Code (for example, §1.197-2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

(vi) A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or *vice versa*, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).

(vii) For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(d)(2)(vii), the term *mass assets* means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

(viii) Any other change in depreciation or amortization as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(3) *Changes in depreciation or amortization that are not a change in method of accounting*. Section 1.446-1(e)(2)(ii)(b) applies to determine whether a change in depreciation or amortization is not a

change in method of accounting. Further, the following changes in depreciation or amortization are not a change in method of accounting:

(i) *Useful life.* An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is not a change in method of accounting. This paragraph (e)(2)(ii)(d)(3)(i) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1), section 168(c), section 168(g)(2) or (3), section 197), the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(d)(3)(v) of this section applies). See paragraph (e)(2)(ii)(d)(5)(iv) of this section for determining the taxable year in which to correct an adjustment in useful life that is not a change in method of accounting.

(ii) *Change in use.* A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

(iii) *Elections.* Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(d)(3)(iii) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling. For making or revoking an

election under section 179 of the Internal Revenue Code, see section 179(c) and §1.179-5.

(iv) *Salvage value.* Except as provided under paragraph (e)(2)(ii)(d)(2)(v) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

(v) *Placed-in-service date.* Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. For example, if a taxpayer changes the placed-in-service date of a depreciable or amortizable asset because the taxpayer incorrectly determined the date on which the asset was placed in service, such a change is a change in the placed-in-service date of the asset and, therefore, is not a change in method of accounting. However, if a taxpayer incorrectly determines that a depreciable or amortizable asset is nondepreciable property and later changes the treatment of the asset to depreciable property, such a change is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(d)(2) of this section. Further, a change in the convention of a depreciable or amortizable asset is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(d)(2)(i) of this section. See paragraph (e)(2)(ii)(d)(5)(v) of this section for determining the taxable year in which to make a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting.

(vi) Any other change in depreciation or amortization as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(4) *Item being changed.* For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a

depreciable asset for which depreciation is determined under §1.167(a)-11 (class life asset depreciation range (CLADR) property). Similarly, the item is the depreciable treatment of each general asset account with respect to a depreciable asset for which general asset account treatment has been elected under section 168(i)(4) or the item is the depreciation treatment of each mass asset account with respect to a depreciable asset for which mass asset account treatment has been elected under former section 168(d)(2)(A). Further, a change in computing depreciation or amortization under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is permitted only with respect to all assets in a particular account (as defined in §1.167(a)-7) or vintage account.

(5) *Special rules.* For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies—

(i) *Declining balance method to the straight line method for MACRS property.* For tangible, depreciable property subject to section 168 (MACRS property) that is depreciated using the 200-percent or 150-percent declining balance method of depreciation under section 168(b)(1) or (2), a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method of depreciation in the first taxable year in which the use of the straight line method with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. 87-57, 1987-2 C.B. 687, and §601.601(d)(2)(ii)(b) of this chapter).

(ii) *Depreciation method changes for section 167 property.* For a depreciable or amortizable asset for which depreciation is determined under section 167 (other than

under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))), see §1.167(e)-1(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see §1.167(a)-11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see §1.167(a)-11(b)(4)(iii)(c) for how to correct an incorrect classification or characterization of CLADR property.

(iii) *Section 481 adjustment.* Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, no section 481 adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, for example, see section 2.06 of Rev. Proc. 97-27, 1997-1 C.B. 680, section 2.06 of Rev. Proc. 2002-9, 2002-1 C.B. 327, and §601.601(d)(2)(ii)(b) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or *vice versa*) or a change in the treatment of an asset from expensing to depreciating (or *vice versa*) results in a section 481 adjustment.

(iv) *Change in useful life.* This paragraph (e)(2)(ii)(d)(5)(iv) applies to an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation

deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) and that is not a change in method of accounting under paragraph (e)(2)(ii)(d) of this section. For this adjustment in useful life, no section 481 adjustment is required or permitted. The adjustment in useful life, whether initiated by the Internal Revenue Service (IRS) or a taxpayer, is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)-1(b) (or if the period of limitation for assessment under section 6501(a) has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations (for example, the useful life is incorrectly determined in the placed-in-service year), the adjustment in the useful life, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the correction in useful life, in lieu of filing amended Federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)-1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years.

(v) *Change in placed-in-service date.* This paragraph (e)(2)(ii)(d)(5)(v) applies to a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting under paragraph (e)(2)(ii)(d) of this section. For this change in placed-in-service date, no section 481 adjustment is required or permitted. The change in placed-in-service date, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-ser-

vice year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended Federal tax returns, the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

(iii) *Examples.* The rules of this paragraph (e) are illustrated by the following examples:

*Example 1.* Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

*Example 2.* A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

*Example 3.* A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

*Example 4.* From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

*Example 5.* A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

*Example 6.* A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valu-

ing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Internal Revenue Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

*Example 7.* A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a “reserve for price changes.” Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Internal Revenue Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

*Example 8.* A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

*Example 9.* In 2003, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of \$10,000,000 for use in its manufacturing operations. A1 classified the \$10,000,000 as nonresidential real property under section 168(e). A1 elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003, 2004, and 2005 Federal tax returns, A1 depreciated the \$10,000,000 under the general depreciation system of section 168(a), using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. In 2006, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of \$1,500,000 as section 1245 property. As a result, the \$1,500,000 should have been classified in 2003 as 5-year property under section 168(e) and depreciated on A1’s 2003, 2004, and 2005 Federal tax returns under the general depreciation system, using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, A1’s change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

*Example 10.* In 2003, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of \$1,000,000 for use in its plant located outside the United States. The equipment is 15-year property under section 168(e) with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g). However, B incorrectly depreciated

the equipment under the general depreciation system of section 168(a), using the 150-percent declining balance method, a 15-year recovery period, and the half-year convention. In 2010, the IRS examines B’s 2007 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

*Example 11.* In May 2003, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. C never held this equipment for sale. However, C incorrectly treated the equipment as inventory on its 2003 and 2004 Federal tax returns. In 2005, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, C’s change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 adjustment.

*Example 12.* Since 2003, D, a calendar year taxpayer, has used the distribution fee period method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000–38, 2000–2 C.B. 310, and §601.601(d)(2)(ii)(b) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(d)(2)(vi) of this section. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

*Example 13.* Since 2003, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identified any dispositions of these mass assets by specific identification. Because of changes in E’s recordkeeping in 2006, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(d)(2)(vii) of this section, this change is a change in method of accounting. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

*Example 14.* In August 2003, F, a calendar year taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7-year property under section 168(e). F elected not to deduct the additional first year depreci-

ation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003 and 2004 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a), using the 200-percent declining balance method of depreciation, a 7-year recovery period, and the half-year convention. In 2005, F realizes that the copier is 5-year property and should have been depreciated on its 2003 and 2004 Federal tax returns under the general depreciation system using a 5-year recovery period rather than a 7-year recovery period. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, F’s change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the copier is depreciated under section 168.

*Example 15.* In 2004, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 intangible and that is not described in section 167(f). G amortized the cost of the intangible asset under section 167(a) using the straight line method of depreciation and a determinable useful life of 13 years. The safe harbor useful life of 15 or 25 years under §1.167(a)–3(b) does not apply to the intangible asset. In 2008, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(d)(3)(i) of this section, G’s change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin.

*Example 16.* In July 2003, H, a calendar year taxpayer, purchased and placed in service “off-the-shelf” computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5-year property under section 168(e). On its 2003 Federal tax return, H elected to depreciate its 5-year property placed in service in 2003 under the alternative depreciation system of section 168(g) and H elected not to deduct the additional first year depreciation provided by section 168(k). The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5-year recovery period, and the half-year convention. In 2005, H realizes that the cost of the software should have been amortized under section 167(f)(1), using the straight line method of depreciation, a 36-month useful life, and a monthly convention. H’s change from 5-years to 36-months is a change in method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1). The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 adjustment.

*Example 17.* On May 1, 2003, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of \$500,000 for use in its busi-

ness. The equipment is 5-year property under section 168(e) with a class life of 9 years and is qualified property under section 168(k)(2). I2 did not place in service any other depreciable property in 2003. Section 168(g)(1)(A) through (D) do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) for 5-year property placed in service in 2003. However, I2 did not make the election. Instead, I2 deducted on its 2003 Federal tax return the 30-percent additional first year depreciation attributable to the equipment and, on its 2003 and 2004 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In 2005, I2 realizes its failure to make the alternative depreciation system election in 2003 and files a Form 3115, "Application for Change in Accounting Method," to change its method of depreciating the remaining adjusted depreciable basis of the 2003 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2003) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(d)(3)(iii) of this section. Instead, I2 must submit a request for a private letter ruling under §301.9100-3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2003 Federal tax return.

*Example 18.* On December 1, 2004, J, a calendar year taxpayer, purchased and placed in service 20 previously-owned adding machines. For the 2004 taxable year, J incorrectly classified the adding machines as items in its "suspense" account for financial and tax accounting purposes. Assets in this suspense account are not depreciated until reclassified to a depreciable fixed asset account. In January 2006, J realizes that the cost of the adding machines is still in the suspense account and reclassifies such cost to the appropriate depreciable fixed asset account. As a result, on its 2004 and 2005 Federal tax returns, J did not depreciate the cost of the adding machines. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, J's change in the treatment of the adding machines from non-depreciable assets to depreciable assets is a change in method of accounting. The placed-in-service date exception under paragraph (e)(2)(ii)(d)(3)(v) of this section does not apply because the adding machines were incorrectly classified in a nondepreciable suspense account. This method change results in a section 481 adjustment.

*Example 19.* In December 2003, K, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. However, K did not receive the invoice for this equipment until January 2004. As a result, K classified the equipment on its fixed asset records as being placed in service in January 2004. On its 2004 and 2005 Federal

tax returns, K depreciated the cost of the equipment. In 2006, K realizes that the equipment was actually placed in service during the 2003 taxable year and, therefore, depreciation should have begun in the 2003 taxable year instead of the 2004 taxable year. Pursuant to paragraph (e)(2)(ii)(d)(3)(v) of this section, K's change in the placed-in-service date of the equipment is not a change in method of accounting.

\* \* \* \* \*

(4) *Effective date*—(i) *In general.* Except as provided in paragraphs (e)(3)(iii) and (e)(4)(ii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.446-1(e) in effect prior to December 30, 2003 (§1.446-1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) *Changes involving depreciable or amortizable assets.* With respect to paragraph (e)(2)(ii)(d) of this section, paragraph (e)(2)(iii) *Examples 9 through 19* of this section, and the language "certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section)" in the last sentence of paragraph (e)(2)(ii)(a) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003.

#### §1.446-1T [Removed]

Par. 7. Section 1.446-1T is removed.

Par. 8. Section 1.1016-3 is amended by revising paragraphs (h) and (j) to read as follows:

*§1.1016-3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.*

\* \* \* \* \*

(h) *Application to a change in method of accounting.* For purposes of determining whether a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(c), to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168), or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) is a change in method of accounting under section 446(e) and the regulations under section 446(e), section 1016(a)(2) does not permanently affect a taxpayer's lifetime income.

\* \* \* \* \*

(j) *Effective date*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.1016-3 in effect prior to December 30, 2003 (§1.1016-3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(2) *Depreciation or amortization changes.* Paragraph (h) of this section applies to a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(c), to former section 168, or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) for taxable years ending on or after December 30, 2003.

#### §1.1016-3T [Removed]

Par. 9. Section 1.1016-3T is removed.

Kevin M. Brown,  
Deputy Commissioner for  
Services and Enforcement.

Approved December 21, 2006.

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

(Filed by the Office of the Federal Register on December 22, 2006, 8:45 a.m., and published in the issue of the Federal Register for December 28, 2006, 71 F.R. 78066)

## Section 863.—Special Rules for Determining Source

26 CFR 1.863–8: Source of income derived from space and ocean activity under section 863(d).

### T.D. 9305

#### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

**SUMMARY:** This document contains final regulations under section 863(d) governing the source of income from certain space and ocean activities. It also contains final regulations under section 863(a), (d), and (e) governing the source of income from certain communications activities. In addition, this document contains final regulations under section 863(a) and (b), amending the regulations in §1.863–3 to conform those regulations to these final regulations. The final regulations primarily 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). The final regulations also affect persons who derive income from transmission of communications.

**DATES:** *Effective Date:* These regulations are effective December 27, 2006.

*Applicability Date:* For dates of applicability, see §1.863–8(h) and §1.863–9(l).

FOR FURTHER INFORMATION CONTACT: H. Michael Huynh, (202) 435–5161 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Paperwork Reduction Act

The collections of information contained in these final regulations 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 collections of information in these final regulations are in §§1.863–8(g) and 1.863–9(k). 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.

The estimated annual burden per respondent is 5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

##### Background

Congress enacted section 863(d) and (e) as part of the Tax Reform Act of 1986, Pub. L. No. 99–514, 100 Stat. 2085. Section 863(d) governs the source of income derived from space or ocean activities. Section 863(e) governs the source of income derived from international communications activities.

The Treasury Department and the IRS published a notice of proposed rulemaking (REG–106030–98, 2001–1 C.B. 820) in

the **Federal Register** on January 17, 2001 (66 FR 3903), which provided proposed regulations under section 863(a), (b), (d), and (e) (the 2001 proposed regulations). The Treasury Department and 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 (AJCA), Pub. L. No. 108–357, 118 Stat. 1418, 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 rules.

In light of the extensive written comments, industry evolution, and AJCA changes, the Treasury Department and the IRS felt that it was appropriate to repropose these regulations to reflect these changes and to provide another opportunity for comment. Consequently, the Treasury Department and the IRS published another notice of proposed rulemaking in the **Federal Register** on September 19, 2005 (REG–106030–98, 2005–2 C.B. 739 [70 FR 54859]), which withdrew the 2001 proposed regulations and provided new proposed regulations under section 863(a), (b), (d), and (e) (the proposed regulations). The proposed regulations provided two sets of rules: one in §1.863–8 for determining the source of income from space or ocean activities, the other in §1.863–9 for determining the source of income from communications activities.

A public hearing on the proposed regulations was scheduled for December 15, 2005, but was ultimately cancelled because no one requested to speak. A few written comments, however, were received. These comments uniformly praised the proposed regulations as an improvement over the 2001 proposed regulations and generally were supportive of much of the proposed regulations. However, commentators suggested a few additional changes. After consideration of these comments, the proposed regulations are adopted as final regulations, as amended by this Treasury decision. The revisions to regulations governing the source of income from space or ocean



activities and the source of income from communications activities are discussed in section A and section B, respectively, of this preamble.

## Summary of Comments and Explanation of Revisions

### A. *Space or Ocean Activity under Section 863(d)*

Section 863(d) governs the source of income from certain space or ocean activities. In general, section 863(d)(1) provides that, except as provided in regulations, any income derived from a space or ocean activity (space and ocean income) is income from sources within the United States (U.S. source income) if derived by a United States person and is income from sources without the United States (foreign source income) if derived by a foreign person. 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 types of activities from the definition of space or ocean activity. Space or ocean activity does not include any activity giving rise to transportation income governed by section 863(c), international communications income governed by section 863(e), or income with respect to mines, oil and gas wells, or other natural deposits to the extent within the United States or any foreign country or possession of the United States (as defined in section 638). See Section 863(d)(2)(B).

Section 1.863-8 of the proposed regulations generally provided rules for determining the source of income derived from space or ocean activity under section 863(d). Section 1.863-8(b)(1) of the proposed regulations reflected the general source rule under section 863(d)(1) that a United States person's space and ocean income is U.S. source income. Pursuant to the grant of regulatory authority under section 863(d)(1), however, the proposed regulations provided an exception to this general rule. Under that exception, a United States person's space and ocean income is foreign source income (and therefore not

sourced on the basis of citizenship or residency) 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.

For a foreign person, proposed §1.863-8(b)(2) reflected the general source rule under section 863(d)(1) that a foreign person's space and ocean income is foreign source income. Pursuant to regulatory authority under section 863(d)(1), however, the proposed regulations contained two exceptions to this general rule, one for controlled foreign corporations (CFCs), the other for foreign persons engaged in a U.S. trade or business. The proposed regulations generally sourced space and ocean income derived by a CFC, like that of a United States person, as U.S. source income. However, also like the rule for a United States person, a CFC's space and ocean income is foreign source income 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. For a foreign person, other than a CFC, engaged in a trade or business within the United States, space and ocean income is U.S. source income to the extent it is attributable to functions performed, resources employed, or risks assumed within the United States.

In addition to the general source rules for United States and foreign persons, the proposed regulations provided special rules, applicable to both United States and foreign persons, for income from services, certain sales of property, and communications activities (other than international communications activities). These special rules, as well as modifications to the proposed regulations, are discussed below.

#### 1. *Activities performed outside space and international water*

Section 1.863-8 of the proposed regulations provided source rules only for income from space or ocean activity. Thus, in some cases, income derived from a transaction must be allocated between space and ocean income and other income.

For example, §1.863-8(b)(3)(ii)(C) of the proposed regulations provided that when property is produced both in space or international water and outside space

and international water, gross income allocable to production activity is allocated to production occurring in space or international water and production occurring outside space and international water based on where functions are performed, resources are employed, or risks are assumed. The proposed regulations also provided a similar analysis of functions performed, resources employed, or risks assumed to allocate income in the case of performance of services. See Prop. Treas. Reg. §1.863-8(d)(2). Under the proposed regulations, only the amount allocated to production or performance of a service occurring in space or international water is treated as space and ocean income (character rule). The source of gross income allocated to production or performance of a service occurring in space or international water is then determined under the rules of proposed §1.863-8(b)(1) or (2), as applicable (source rule).

Section 1.863-8(b)(1) of the proposed regulations reflected the general source rule that a United States person's space and ocean income is U.S. source income. Proposed §1.863-8(b)(2) reflected the general source rule that a foreign person's space and ocean income is foreign source income. Both proposed §1.863-8(b)(1) and (2), however, provided exceptions to their respective general source rules. As discussed above, under the exceptions, a United States person's space and ocean income may be foreign source income and a foreign person's space and ocean income may be U.S. source income based on where functions are performed, resources are employed, or risks are assumed.

One commentator noted that in some situations, the allocation of income derived from a transaction to determine space and ocean income based on functions performed, resources employed, or risks assumed presumably would remove the subsequent need to further analyze functions performed, resources employed, or risks assumed within a country to determine the source of the space and ocean income. In other words, the very act of determining the character of income seems to also determine the source of such income.

The Treasury Department and the IRS agree with the commentator that use of the same standard to classify the transaction as space or ocean activity and to source the space and ocean income may be du-

plicative in some cases. However, there are other cases where a transaction with some land-based activity may be classified in its entirety as a space or ocean activity (for example, a lease of a satellite), but the income may be partially U.S. source and partially foreign source under the source rules of proposed §1.863-8(b)(1) and (2) based on functions performed, resources employed, or risks assumed within the United States or a foreign country. Consequently, the character and source rules are not always duplicative.

Thus, the extent to which the character rules overlap with the source rules is particular to the type of transaction involved. The Treasury Department and the IRS recognize that the overlap in the character and source rules may produce equivalent results. But, the overlap is necessary to provide taxpayers and the IRS with workable rules. As a result, the final regulations do not follow this comment as a general matter.

Nonetheless, a conforming amendment has been made to the lease transaction in *Example 1* in §1.863-8(f) of the final regulations to more clearly illustrate how the rules work. That example illustrates that the transaction involved is first classified in its entirety as a space or ocean activity, and then the resulting space and ocean income is subjected to the source rules. The space and ocean income is sourced as foreign source income 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. Activities performed by another person

Section 1.863-8(a) of the proposed regulations provided that a taxpayer will not be considered to derive income from space or ocean activity if such activity is performed by another person. The approach under §1.863-8(a) of the proposed regulations, providing that a taxpayer derives income from a space or ocean activity only if it conducts such activity directly, is consistent with the approach adopted in the §1.863-3 regulations governing the source of income from certain sales of inventory. See, e.g., Treas. Reg. §1.863-3(c) (“[T]he only production activities that are taken into account for purposes of §§1.863-1,

1.863-2, and this section are those conducted directly by the taxpayer.”).

Accordingly, commentators believed that this provision assured that a content provider that retains a satellite operator to transmit programming abroad would not derive space and ocean income based on attribution of the satellite operator’s activity. The Treasury Department and the IRS agree.

One commentator noted, however, that *Examples 2* and *4* in §1.863-8(f) of the proposed regulations seem to indicate that this is not what was intended. In *Example 2*, the taxpayer, an Internet service provider, transmits information requested by its customer, in part using satellite capacity leased from a third party. *Example 2* concludes that the service performed by the taxpayer is considered space activity to the extent the value of the service is attributable to functions performed, resources employed, and risks assumed in space. In *Example 4*, the taxpayer uses satellite capacity acquired from a third party to deliver programming services directly to its customers’ televisions sets. *Example 4* concludes that the taxpayer’s delivery of programming and other services is considered space activity to the extent the value of the delivery transaction is attributable to performance in space. In the commentator’s view, the results reached in the examples conflict with the provision stating that activities performed by another person are not attributable to the taxpayer.

The Treasury Department and the IRS do not believe that *Examples 2* and *4* of §1.863-8(f) of the proposed regulations produce the result that the commentator raised. In *Examples 2* and *4*, the taxpayer performed the transmission or delivery activities using satellite capacity leased or acquired from a third party. Both *Examples 2* and *4* correctly conclude that the taxpayers derived space and ocean income from their own activities rather than from activities of another person. Thus, the examples do not, in fact, conflict with the text of the proposed regulations. Nevertheless, the Treasury Department and the IRS are concerned that *Examples 2* and *4* have been misinterpreted as suggesting that activities performed by another person may be attributable to the taxpayer in certain situations. This was not the intent of these examples. Consequently, *Examples 2* and *4* in §1.863-8(f) of the final regu-

lations have been modified to make clear that the taxpayers in the examples *directly* engage in a space activity by performing the uplink (transmitting to the satellite) and downlink functions.

These examples differ from cases in which the taxpayer is a mere content provider that derives income either from the creation of content or from the creation and delivery of content, but in either case contracts with another person to deliver the content via satellite. Pursuant to §1.863-8(a) of the final regulations, content providers of this type would not derive space and ocean income because the delivery of the content via satellite is performed by another person. This would be the result even though the value of the customer contract includes a payment to the content provider for space or ocean activity. To clarify the distinction between these situations and *Examples 2* and *4*, a new *Example 5* has been added to the final regulations. That example involves a content provider that does not derive space and ocean income because the taxpayer does not directly perform any space or ocean activity.

## 3. Income characterization rules for income from services and the de minimis exception

Under §1.863-8(b)(4) of the proposed regulations, to the extent a service is characterized as space or ocean activity, the source of gross income derived from such transaction is determined under proposed §1.863-8(b)(1) or (2), as applicable. Section 1.863-8(d)(2)(ii)(B) of the proposed regulations provided, however, that 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 water is *de minimis*, such service will not be treated as space or ocean activity. The *de minimis* rule was adopted to address taxpayers’ concerns about potential confusion in qualifying for the “facilitation exception” under the 2001 proposed regulations. One commentator stated that the *de minimis* rule simply replaced one vague standard with another, as neither *Example 3* in §1.863-8(f) of the proposed regulations nor the text of the proposed regulations provides any guidance as to when activities performed in space or international water would be

*de minimis* under a facts and circumstances approach.

The Treasury Department and the IRS recognize that issues of interpretation may arise in any facts and circumstances approach. Nevertheless, the Treasury Department and the IRS generally have refrained from adopting the alternative approach, to wit, adopting precise definitions and quantitative measures for a *de minimis* standard. Moreover, the inclusion of a precise definition and quantitative measures for determining *de minimis* value could raise equal, if not greater, concerns in terms of the quantitative threshold and other issues. Thus, the final regulations retain the *de minimis* standard for determining whether a taxpayer has space and ocean income. If the value of the service attributable to space or ocean activity is *de minimis* based on the facts and circumstances, the taxpayer will not derive space and ocean income. Nevertheless, the Treasury Department and the IRS agree that more guidance could be provided as to the application of the retained *de minimis* rule. Accordingly, *Examples 3 and 8* in §1.863-8(f) of the final regulations (*Example 7* in the proposed regulations) provide clearer illustrations of when activities performed in space or international water would be considered *de minimis* for this purpose and when those types of activities would not be considered *de minimis*.

#### 4. Source rules for income from certain sales of property

The proposed regulations provided special rules for income from certain sales of property, either when any production occurs in space or international water, or when the sale occurs in space or international water. In either case, section 863(d) and the proposed regulations applied to determine the source of income from the sales of property, and the rules of sections 861(a)(6), 862(a)(6), 863(a), 863(b), and 865 apply only to the extent provided in the proposed regulations.

##### a. Sales of Property Produced in the United States and Sold in Space or International Water

Section 1.863-8(b)(3)(ii) of the proposed regulations provided that when the taxpayer both produces property and sells such property, one-half of the tax-

payer's gross income will be considered income allocable to production activity and one-half of such gross income will be considered income allocable to sales activity. Taxpayers generally must then apply the rules of section 863(d) and the proposed regulations to determine the source of income allocable to production activity and sales activity.

For production activity, the source of gross income allocable to production occurring in space or international water is generally based on the citizenship or residence of the taxpayer, applying the rules of proposed §1.863-8(b)(1) or (2), as applicable. The source of gross income allocable to production occurring outside space and international water is determined under section 863(b) rather than section 863(d). See Prop. Treas. Reg. §1.863-8(b)(3)(ii)(B) (referencing Treas. Reg. §1.863-3(c)(1)).

As for sales activity, when property is sold in space or international water, the source of gross income allocable to sales activity is generally based on the citizenship or residence of the taxpayer, applying the rules of proposed §1.863-8(b)(1) or (2), as applicable. An exception to this general rule applied in cases when the property sold is inventory, 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, and the United States. In that case, the source of gross income allocable to sales activity is determined under Treas. Reg. §1.861-7(c) and §1.863-3(c)(2). Treas. Reg. §1.861-7(c) and §1.863-3(c)(2) generally provide for foreign source income where the seller's rights, title, and interest in the property are transferred to the buyer (the title passage rule) outside the United States and the property is not sold for use, consumption, or disposition in the United States. Treas. Reg. §1.861-7(c) and §1.863-3(c)(2) also applied to property sold outside space and international water. See Prop. Treas. Reg. §1.863-8(b)(3)(ii)(D).

One commentator believed that because certain U.S. manufacturers, such as U.S. satellite manufacturers, produce property that is sold in space or international water for use, consumption, or disposition in space or international water, they are at a disadvantage relative to U.S. manufacturers of other export property because

the former may have U.S. source income with respect to income allocable to sales activity, while the latter may have foreign source income from sales activity.

In response to comments on the 2001 proposed regulations, proposed §1.863-8(b)(1) was revised to provide that space and ocean income will be foreign source income to the extent the space and ocean income is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries. The Treasury Department and the IRS believe that this change may in many cases mitigate concerns about U.S. manufacturers potentially deriving 100 percent U.S. source income in these cases. Moreover, the Treasury Department and the IRS believe that the rules under the proposed regulations for determining the source of income allocable to sales activity are consistent with legislative intent to assert primary tax jurisdiction over income earned by United States persons that is not subject to foreign tax. See S. REP. NO. 99-313, 1986-3 C.B. 357-358 (“[T]he committee believes the United States should assert primary tax jurisdiction over income earned by its residents that is not within any foreign country's taxing jurisdiction.... Moreover, when a U.S. taxpayer conducts activities in space or international waters, foreign countries generally do not tax the income. Thus, the foreign tax credit limitation is inflated by income that is not within any foreign country's tax jurisdiction.”). Based on the legislative history, 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, international water, and the United States — should be considered space or ocean activity and that the source of income from such sales activity should be determined under section 863(d). As a result, no changes were made in response to this comment.

##### b. Purchased Versus Produced Property Sold for Use, Consumption, or Disposition in the United States

One commentator questioned the appropriateness of differences in determining the source of sales income depending

on whether the taxpayer produced or purchased the property sold. Under the proposed regulations, when property produced by the taxpayer is sold in space or international water, the source of gross income allocable to sales activity is generally based on the citizenship or residence of the taxpayer, applying the rules of proposed §1.863-8(b)(1) or (2), as applicable (and not the title passage rule) — subject to the foregoing inventory exception for property that will be used, consumed, or disposed of outside space, international water, and the United States. A slightly different rule applied to sales of property that had been purchased by the taxpayer. While the proposed regulations also provided that, for purchased property, the source of gross income allocable to sales activity is generally based on the citizenship or residence of the taxpayer, the inventory exception for purchased property only required that the property be used, consumed, or disposed of outside space and international water.

The inventory exceptions for produced and purchased property were intended to produce different results when inventory property is used, consumed, or disposed of in the United States. In such case, the source of produced inventory property sales income is generally based on the citizenship or residence of the taxpayer, applying the rules of proposed §1.863-8(b)(1) or (2), because the inventory exception did not extend to produced property sold for use, consumption, or disposition in the United States. In contrast, the source of purchased inventory property sales income is generally based on title passage under Treas. Reg. §1.861-7(c) because the inventory exception did extend to purchased property even if it was sold for use, consumption, or disposition in the United States. The Treasury Department and the IRS believe that this difference between the produced and purchased property rules in the space and ocean context is consistent with the difference in the rules for sales of produced and purchased property outside the space and ocean context. In particular, under section 863(a) and (b) and the regulations thereunder, if property is produced in the United States and sold for use, consumption, or disposition in the United States, the place of sale will be presumed to be the United States, and income attributable to the sales

activity will be U.S. source income. See §1.863-3(c)(2). There is, however, no comparable rule for purchased property under section 862(a)(6) or the regulations thereunder. Thus, the final regulations simply continue in the space and ocean context the varying treatment elsewhere for sales of purchased property and sales of produced property.

In response to comments, however, the produced and purchased property rules have been modified to be similar in structure and style, to better reflect and highlight the differences between these two rules.

#### 5. *Allocations*

Taxpayers must allocate gross income under paragraphs (b)(1) and (b)(2) of proposed §1.863-8 among U.S., foreign, and space or ocean activities. Under proposed §1.863-8(b)(3)(ii)(C), allocations are also made between production activity occurring in space or international water and that occurring outside space and international water. Finally, allocations are also made under proposed §1.863-8(b)(4) between services performed in space or international water and services performed outside space and international water. In performing these allocations, the proposed regulations generally provided that taxpayers should consider the relative value of functions performed, resources employed, or risks assumed in different locations. Moreover, the preamble to the proposed regulations provided that allocations should be based generally on section 482 principles. Commentators noted that little guidance is given as to the mechanics of allocation other than the statement that the principles of section 482 should be used. Commentators stated that allocation of gross income based on section 482 principles will result in added expense, uncertainty, and extra burden on multinational taxpayers who are already required to undertake and update functional analyses and satisfy substantial documentation requirements.

While the final regulations were not changed in response to these comments, the Treasury Department and the IRS believe that some clarification is warranted. In suggesting the use of section 482 principles as a guide, the Treasury Department and the IRS intend for taxpayers to

adopt a reasonable approach to the allocations required in this area. Taxpayers know their businesses and will generally be in the best position to fashion a reasonable method that most reliably reflects the relative value of functions performed, resources employed, and risks assumed in different locations. In the preamble to the proposed regulations, the Treasury Department and the IRS solicited comments on alternative methods of allocation for particular industries and criteria that could be used to evaluate the reasonableness of such methods. No such comments were received. One commentator noted, however, that the proposed regulations perhaps reflected what taxpayers in these industries have already been doing in order to determine the character and source of their space and ocean income. Consequently, the Treasury Department and the IRS believe that allocations of gross income based on functions performed, resources employed, and risks assumed are appropriate in these circumstances.

#### 6. *Separation of a single transaction and aggregation of multiple transactions*

Paragraphs (d)(1)(i) and (d)(1)(ii) of §1.863-8 of the proposed regulations provided that for purposes of determining space or ocean activity, the Commissioner may separate parts of a single transaction or combine separate transactions into a single transaction. One commentator stated that this is a “one-way” street, as only the Commissioner has the authority to separate or combine transactions for purposes of the proposed regulations.

The final regulations do not change this rule. The Treasury Department and the IRS believe taxpayers are not inappropriately disadvantaged by this rule because taxpayers generally have the ability to structure their transactions in line with the economic prospects of their businesses. In addition, the Commissioner’s ability to separate or combine transactions is not unfettered. Rather, the Commissioner may only separate or combine transactions to better reflect the value of functions performed, resources employed, or risks assumed. A taxpayer can always protect itself against recharacterization by adopting an arrangement that appropriately reflects the economic realities of a transaction or series of transactions. The

taxpayer is clearly in the best position at the outset to structure its arrangements in this manner. In addition, taxpayers traditionally are not permitted to restructure retroactively the form of their completed transactions. Thus, the Treasury Department and the IRS believe that the limited “one-way” rule is appropriate in this case.

#### *7. Income derived from the leasing of shipping cargo containers*

One commentator requested that the Treasury Department and the IRS make clear that the final regulations under section 863(d) do not apply to income derived from the leasing of shipping cargo containers and that such income should be treated as rental income, sourced under sections 861 and 862. This commentator noted that valid arguments also exist for treating income derived from the leasing of shipping cargo containers as transportation income; however, in the commentator’s view, the most appropriate treatment is rental income treatment, sourced under sections 861 and 862.

The treatment of income derived from the leasing of shipping cargo containers is not covered by these final regulations. Instead, the Treasury Department and the IRS intend to address the treatment of such income explicitly in separate guidance. That guidance may apply section 863(c), section 863(d), or other provisions to source income derived from the leasing of shipping cargo containers. Any such guidance will be prospective in nature. Until such time, the treatment of such income will be determined under existing law.

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

Section 863(e) governs the source of income from international communications activities (international communications income). International communications income is defined in section 863(e)(2) as income derived from the transmission of communications or data between the United States and a foreign country (or possession of the United States). Section 863(e)(1)(A) provides that any international communications income of a United States person is sourced 50 percent in the United States and 50 percent outside the

United States (50/50 source rule). Section 863(e)(1)(A) does not provide for any statutory or regulatory exceptions to this 50/50 source rule. In contrast, section 863(e)(1)(B)(i) provides that any international communications income of a foreign person is sourced outside the United States, except as provided in regulations or in section 863(e)(1)(B)(ii). The exception under section 863(e)(1)(B)(ii) provides that if a foreign person maintains an office or other fixed place of business in the United States, any international communications income attributable to such office or other fixed place of business is U.S. source income.

Section 1.863–9 of the proposed regulations generally provided rules for determining the source of international communications income under section 863(e) and other communications income under section 863(a) and (d). Proposed §1.863–9(b)(1) reflected the rule under section 863(e)(1)(A) that a United States person’s international communications income is 50 percent U.S. source income and 50 percent foreign source income. Proposed §1.863–9(b)(2) reflected the general rule under section 863(e)(1)(B) that a foreign person’s international communications income is foreign source income.

Consistent with the statutory exception under section 863(e)(1)(B)(ii), proposed §1.863–9(b)(2)(iii) provided that any 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 U.S. source income. 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. In addition to the statutory exception under section 863(e)(1)(B)(ii), section 863(e)(1)(B) provides general regulatory authority to depart from the general 100 percent foreign source rule for foreign persons. Thus, pursuant to this regulatory authority, the proposed regulations contained additional exceptions to the general rule applicable to foreign persons. In particular, the proposed regulations provided that international communications income derived by a CFC is 50 percent U.S. source income

and 50 percent foreign source income (the same as for United States persons). The proposed regulations also provided that 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.

In addition to the general source rules for international communications income of United States and foreign persons, the proposed regulations also provided rules, applicable to both United States and foreign persons, for income from U.S. communications, foreign communications, space/ocean communications, and communications where endpoints are indeterminate. These rules, as well as modifications to the proposed regulations, are discussed below.

#### *1. Income characterization rules for communications income*

Section 1.863–9(h)(3) of the proposed regulations provided that the type of communications activity (and thus the applicable source rule) is determined by identifying the two points between which the taxpayer is paid to transmit the communication. For United States and foreign persons, U.S. communications income is entirely U.S. source income. A taxpayer derives U.S. communications income when the taxpayer is paid to transmit between two points in the United States or between the United States and a point in space or international water. In contrast, foreign communications income is entirely foreign source income for United States and foreign persons. A taxpayer derives foreign communications income when the taxpayer is paid to transmit between two points in a foreign country or countries (or a possession or possessions of the United States), between a foreign country and a possession of the United States, or between a foreign country (or a possession of the United States) and a point in space or international water. Finally, the proposed regulations provided different source rules for international communications income of United States and foreign persons. See section B.3 of this preamble for further

discussion. A taxpayer derives international communications income 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). When a taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication, §1.863-9(f) of the proposed regulation provided a default source rule under which all the income derived by the taxpayer from such communications activity is U.S. source income.

Commentators stated that the treatment of communications income as U.S. source income when the endpoints are indeterminate is overbroad and harsh, particularly as it relates to foreign taxpayers. Commentators also stated that taxpayers would have to commit significant resources to develop the technology necessary to identify the endpoints of communications. One commentator stated that it is unclear that a reliable system can be created at any expense to establish the endpoints of the transmission under all circumstances. Commentators suggested instead the use of any reasonable method to establish the endpoints between which a taxpayer is paid to transmit the communications. One commentator suggested that the Treasury Department and the IRS consider employing the Industry Issue Resolution Program or Prefiling Agreement Program as aids in the administration of a reasonable method rule.

The Treasury Department and the IRS solicited 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 solicited comments on methods to establish 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. In response, one commentator submitted examples of reasonable methods to establish the endpoints between which a taxpayer is paid to transmit the communications. The examples relied on statistical reports of data such as minutes used, areas of transmission, port locations, and transport charges. This commentator noted that current federal regulations already require telecommunications companies to submit some of these reports

to certain governmental agencies, for example, the Federal Communications Commission.

In light of the potential complexity in identifying the type of communications activity and in response to comments, the final regulations provide that a taxpayer may satisfy the requirement that the taxpayer establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication by using any consistently applied reasonable method to establish one or both endpoints. In doing so, the taxpayer carries the burden of proof and must establish that the method used is reasonable (taking into account all of the facts and circumstances) and is consistently applied. In satisfying its burden of proof, a taxpayer will need to maintain reasonable records of communications activities. Depending on the facts and circumstances, methods based on, for example, records of port or transport charges, customer billing records, a satellite footprint, or records of termination fees made pursuant to an international settlement agreement may be reasonable. In addition, practices used by taxpayers to classify or categorize certain communications activity in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint ventures, or other parties or governmental agencies in interest may be reliable indicators of the reasonableness of the method chosen, but need not be accorded conclusive weight by the Commissioner. Furthermore, in evaluating the reasonableness of the method chosen, consideration will be given to all the facts and circumstances, including whether the endpoints would otherwise be identifiable absent this reasonable method provision.

Along with resultant changes made to the text of the final regulations, several examples have been added to §1.863-9(j) of the final regulations that illustrate instances where the taxpayer may be able to use reasonable methods to determine the endpoints between which the taxpayer is paid to transmit the communications.

## *2. The paid-to-do rule with respect to foreign-originating communications*

Under the proposed regulations, a taxpayer derives income from a certain type of communications activity (for example,

foreign communications or international communications) only if the taxpayer is paid to transmit, and bears the risk of transmitting (the paid-to-do rule), the communications of such type. See Prop. Treas. Reg. §1.863-9(h)(2) and (3). This is the case even if the taxpayer contracts out the transmission function.

Commentators stated that application of the paid-to-do rule in all instances would give rise to results that are inconsistent with Congressional intent and may result in excessive amounts of U.S. source income. One commentator noted that in some cases, while it is clear that a communication originated in a foreign country and that a U.S. telecommunications company is paid to terminate the foreign-originating traffic in the United States, it is unclear exactly where the U.S. telecommunications company picked up the communication. This lack of clarity often may be due to legal restrictions in certain foreign countries on ownership of capacity and carriage of transmissions by non-nationals. It can also be due to the fact that the international settlement agreements under which major international telecommunications carriers operate often do not specify where the traffic is picked up or handed off, and in some cases the hand-off point is specified by reference to a mid-point convention, even though the transmission signal, from a technical standpoint, travels from end-to-end with no real points in-between. The commentator further stated that at the time section 863(e) was enacted, U.S. carriers were generally not allowed to own and operate facilities in foreign countries; specifically, no U.S. carrier could carry a foreign-to-U.S. or U.S.-to-foreign transmission end-to-end. Thus, concluded the commentator, Congress focused on the endpoints of the communications rather than where the activities constituting the transmission of communications take place. The commentator suggested a rule that would provide that when a taxpayer is paid to transmit foreign-originating communications from a point outside the United States to a point in the United States, the taxpayer should be deemed to have been paid to transmit the communications from a point in the foreign country in which the communication originated.

Upon further consideration, the Treasury Department and the IRS believe that

the paid-to-do rule may be over-inclusive in certain cases. Accordingly, the final regulations provide that international communications income also includes income derived from communications activity when the taxpayer is paid to transmit foreign-originating communications (communications with a beginning point in a foreign country or a possession of the United States) from a point in space or international water to a point in the United States. Also, a new example has been added to §1.863-9(j) of the final regulations to illustrate the changes made in the final regulations with respect to foreign-originating communications.

The changes made in the final regulations only affect communications that originate in a foreign country (or a possession of the United States) and does not affect communications that originate in space, international water, or 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.

### *3. Determining the source of communications income based on functions performed, resources employed, or risks assumed in a foreign country or countries*

As discussed above, the proposed regulations provided that the source of communications income is largely dependant on the type of communications activity and the citizenship or residence of the taxpayer. However, the proposed regulations provided for two instances where (in addition to the type of communications activity and the citizenship or residence of the taxpayer) the source of communications income may depend on functions performed, resources employed, or risks assumed. First, the proposed regulations provided that 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 U.S. source income. The proposed regulations provided that international communications income is attributable to an office or other fixed place of business to the extent of functions performed, re-

sources employed, or risks assumed by the office or other fixed place of business. Second, the proposed regulations provided that 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.

Commentators suggested that the final regulations also provide for similar rules that would source communications income as foreign source income based on functions performed, resources employed, or risks assumed in a foreign country or countries. For example, one commentator suggested that the source of international and U.S. communications income derived by any United States or foreign person (including branches, partnerships, and disregarded entities) engaged in a trade or business in a foreign country or countries 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 such foreign country or countries.

While the Treasury Department and the IRS recognize that commentators' suggestion to provide for a source rule based on functions performed, resources employed, or risks assumed in a foreign country or countries is reasonable, as explained below, the Treasury Department and the IRS believe that the statute and legislative history preclude such an option.

#### **a. International Communications Income**

Consistent with section 863(e)(1)(A), proposed §1.863-9(b)(1) provided that international communications income of a United States person is 50 percent U.S. source income and 50 percent foreign source income. One commentator suggested that it may be appropriate, in certain situations, to depart from the 50/50 source rule to provide special rules for foreign activities. According to the commentator, as a result of local regulatory requirements, U.S.-based international telecommunications providers often need to conduct portions of their international business through locally formed entities, and such

entities are fully subject to foreign tax on their income. The commentator therefore concluded that a source rule for international communications income based on functions performed, resources employed, or risks assumed in a foreign country or countries is not only equitable but also consistent with treatment accorded to foreign persons having a U.S. fixed place of business or engaged in a U.S. trade or business.

The Treasury Department and the IRS recognize that a source rule based on functions performed, resources employed, or risks assumed may be a reasonable alternative to the 50/50 source rule. Nonetheless, they continue to believe that the 50/50 source rule is the method that must be used to determine the source of a United States person's international communications income. This is because section 863(e)(1)(A) provides for an explicit 50/50 source rule for those persons without exception. In contrast, section 863(e)(1)(B) provides that a foreign person's international communications income is generally sourced outside the United States, except as provided in regulations. The Treasury Department and the IRS believe that the express grant of regulatory authority in the case of foreign persons and the omission of any such authority in the case of United States persons indicate that Congress intended the 50/50 sourcing rule be applied to United States persons without regulatory modification. There is nothing in the statute or legislative history that clearly demonstrates a different intention. In contrast, section 863(e)(1)(B)(ii) provides for a special source rule with respect to foreign persons with an office or other fixed place of business in the United States. A similar rule is not provided with respect to a United States person's foreign activities. Thus, Congress chose a rule that sourced international communications income of foreign persons in certain instances based on the place of their activities, but expressly chose the 50/50 method to source international communications income of United States persons, regardless of the place of their activities.

The Treasury Department and the IRS recognize that the statute does not require strict application of the 50/50 source rule for CFCs. Section 863(e)(1)(B) only provides that the international communications income of a foreign person is

foreign source income, except as provided in regulations. Consistent with and in light of this regulatory authority, however, the Treasury Department and the IRS believe that the 50/50 source rule is the most appropriate method to determine the source of a CFC's international communications income. This approach addresses the concern of the Treasury Department and the IRS that United States persons may use CFCs to obtain benefits that are inconsistent with the purposes of section 863(e). Consequently, the rules for determining the source of international communications income derived by a CFC should be the same as the rules for determining the source of such income if it is derived by a United States person. In addition, the Treasury Department and the IRS believe that the 50/50 source rule for CFCs, as opposed to the 100 percent U.S. source rule that was originally proposed as part of the 2001 proposed regulations, should limit the potential for multiple levels of taxation that commentators raised with respect to those prior proposed regulations.

#### b. U.S. Communications Income

Section 1.863-9(c) of the proposed regulations provided that income derived by a United States or foreign person from U.S. communications activity is entirely from sources within the United States. One commentator noted that a foreign person deriving income from the transmission of communications between a point in the United States and another point in the United States or between a point in the United States and a point in space or international water has 100 percent U.S. source income, even if much or all of the activity involved is outside the United States. In contrast, under the space and ocean rules, a foreign person has U.S. source income only to the extent the income is attributable to functions performed, resources employed, or risks assumed within the United States. Commentators therefore suggested modification of the 100 percent U.S. source rule for U.S. communications income derived by United States and foreign persons to take into account foreign activities.

The Treasury Department and the IRS recognize that a source rule based on functions performed, resources employed, or risks assumed may be a reasonable alter-

native to the 100 percent U.S. source rule for U.S. communications. Nonetheless, the Treasury Department and the IRS believe that Congress did not intend such an option. The legislative history indicates that if a communication is between two points within the United States, the "income attributable thereto is to be sourced *entirely* as U.S. source income." S. REP. NO. 99-313, 1986-3 C.B. 359 (emphasis added). Congress intended such a result "even if the communication is routed through a satellite located in space, regardless of the satellite's location." *Id.* Thus, the legislative history clearly provides that Congress intended that U.S. communications income be sourced entirely as U.S. source income.

#### 4. *International communications income derived by a foreign person (other than a CFC)*

Proposed §1.863-9(b)(2) reflected the general rule under section 863(e)(1)(B) that a foreign person's international communications income is foreign source income. Consistent with the statutory exception under section 863(e)(1)(B)(ii), proposed §1.863-9(b)(2)(iii) provided that any 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 U.S. source income. 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. Pursuant to the grant of regulatory authority under section 863(e)(1)(B), the proposed regulations provided other exceptions to the general rule for foreign persons. The first exception is the 50/50 source rule for CFCs under §1.863-9(b)(2)(ii) of the proposed regulations, as discussed above. The second exception was provided in §1.863-9(b)(2)(iv) of the proposed regulations and applied to foreign persons other than CFCs. Section 1.863-9(b)(2)(iv) of the proposed regulations provided that international communications income derived by a foreign person, other than a CFC, engaged in a trade or business within the United States, that is attributable to functions performed, resources

employed, or risks assumed within the United States is U.S. source income. One commentator noted that it is unclear why a separate rule is needed for a fixed place of business in the United States and a U.S. trade or business because international communications income attributable to a fixed place of business in the United States should also be attributable to functions performed, resources employed and risks assumed within the United States.

As indicated, the office or other fixed place of business rule under §1.863-9(b)(2)(iii) of the proposed regulations was derived from the statutory language of section 863(e), while the trade or business rule under §1.863-9(b)(2)(iv) of the proposed regulations was derived from the express grant of regulatory authority to source international communications income of foreign persons as other than foreign source. The Treasury Department and the IRS recognize that in most situations, the latter trade or business rule would indeed subsume the former fixed place of business rule, but still believe that the later rule serves an important function. The trade or business rule addresses 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.

#### 5. *Allocations*

Section 1.863-9(h)(1)(ii) of the proposed regulations provided that 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 part of the transaction must be treated as a separate transaction. Gross income is then allocated to each communications activity transaction and each 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. Moreover, the Treasury Department and the IRS suggested in the preamble to the proposed



regulations that allocations of gross income should be based generally on section 482 principles. One commentator stated that the complexities inherent in allocating income, based on section 482 principles, between the separated transactions are significant.

While the final regulations were not changed in response to this comment, as in the case of allocations for space and ocean income, the Treasury Department and the IRS believe that some clarification is warranted. In suggesting the use of section 482 principles as a guide, the Treasury Department and the IRS intend for taxpayers to adopt a reasonable approach to the allocations required in this area. Taxpayers know their businesses and will generally be in the best position to fashion a reasonable method that most reliably reflects the relative value of functions performed, resources employed, and risks assumed in different locations. In the preamble to the proposed regulations, the Treasury Department and the IRS solicited comments on alternative methods of allocation for particular industries and criteria that could be used to evaluate the reasonableness of such methods. No such comments were received. One commentator noted, however, that the proposed regulations perhaps reflected what taxpayers in these industries have already been doing in order to determine the character and source of their communications income. Consequently, as in the case of space and ocean income, the Treasury Department and the IRS believe that allocations of gross income based on functions performed, resources employed, and risks assumed are appropriate in these circumstances.

### 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 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 en-

ties. 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, the NPRM 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 H. Michael Huynh of the Office of the Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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 derived 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 United States person.* Space and ocean income derived by a United States person is income from sources within the United States. However, space and ocean income derived by a United States 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 United States 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 employed, 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 sold for use, consumption, or disposition outside space and 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 international 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, and 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)).

(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));

(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 in-

ternational 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 and international water 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 United States 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 in its entirety as space activity under paragraph (d)(1)(i) of this section. Income derived from the lease will be sourced 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 per-

forms the uplink and downlink functions. 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. The satellite is used as a medium of delivery and not as a method of surveillance. 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. 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. S can demonstrate, pursuant to paragraph (d)(2)(ii) of this section, that based on all the facts and circumstances, the value of S's service transaction attributable to performance in space is *de minimis*. Thus, 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). O's provision of transponder capacity is viewed as the provision of a service. Based on all the facts and circumstances, the value of O's ser-

vice transaction attributable to performance in space is not *de minimis*. Thus, 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 provision 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. L performs the uplink and downlink functions, 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—(i) Facts.* The facts are the same as in *Example 4*, except that L does not deliver the programming service directly but instead engages R, a domestic corporation specializing in content delivery, to deliver by transmission its pro-

gramming. For all portions of a transmission which require satellite capacity, R, in turn, contracts out such functions to S. S performs the uplink and downlink functions, so that part of the value of the delivery transaction derives from functions performed and resources employed in space.

(ii) *Analysis.* L's activity will not be considered space activity because none of L's activity occurs in space. Thus, L does not derive any space and ocean income. L does, however, derive communications income within the meaning of §1.863-9(h)(2). This is the case even though L does not perform the transmission function because L is paid by Customer C to transmit, and bears the risk of transmitting, the communications or data. To the extent that L's activity consists in part of non-*de minimis* communications and non-*de minimis* non-communications activity, each part of the transaction must be treated as a separate transaction and gross income is allocated accordingly under §1.863-9(h)(1)(ii). In addition, L must also allocate expenses, losses, and other deductions, for example, payments to R, to the class or classes of gross income that include the income so allocated. R's activity will not be considered space activity. Since R contracts out all of the functions involving satellite capacity to S, no part of R's activity occurs in space. Thus, R does not derive any space and ocean income. R does, however, derive communications income within the meaning of §1.863-9(h)(2). This is the case even though R does not perform the transmission function because R is paid by L to transmit, and bears the risk of transmitting, the communications or data. S's activity will be considered space activity. To the extent that S 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 6. Space activity—treatment of land activity—(i) Facts.* S, a United States 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 7. 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 8. 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.* Based on all the facts and circumstances, the value of E's service transaction attributable to performance in space is not *de minimis*. Thus, 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 9. Separate transactions—(i) Facts.* The same facts as *Example 8*, 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 8*.

*Example 10. 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 11. Sale of property in space—(i) Facts.* S, a United States person, manufactures a satellite in the United States and sells it to a customer who is not a United States 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 12. 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 13. 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 14. 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) In 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 main-

tain 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 December 27, 2006.

*§1.863-9 Source of income derived from communications activity under section 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 United States person.* Income derived from international communications activity (international communications income) by a United States 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 United States 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 relative 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. A taxpayer may satisfy the requirement that the taxpayer establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication by using any consistently applied reasonable method to establish one or both endpoints. In evaluating the reasonableness of such method, consideration will be given to all the facts and circumstances, including whether the endpoints would otherwise be identifiable absent this reasonable method provision and the reliability of the data. Depending on the facts and circumstances, methods based on, for example, records of port or transport charges, customer billing records, a satellite footprint, or records of termination fees made pursuant to an international settlement agreement may be reasonable. In addition, practices used by taxpayers to classify or categorize certain communications activity in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint ventures, or other parties or governmental agencies in interest may be reliable indicators of the reasonableness of the method chosen, but need not be accorded conclusive weight by the Commissioner. In all cases, the method chosen to establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication must be supported by sufficient documentation to permit verification by the Commissioner.

(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—

(A) Between a point in the United States and a point in a foreign country (or a possession of the United States); or

(B) Foreign-originating communications (communications with a beginning point in a foreign country or a possession of the United States) from a point in space or international water to a point in 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, except as provided in paragraph (h)(3)(ii)(B) of this section.

(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 United States 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 United States 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 United States 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. The paid-to-do rule—foreign-originating communications—(i) Facts.* Under an international settlement agreement, G, a Country X international carrier, pays T to receive all calls originating in Country X that are bound for the United States and to terminate such calls in the United States. Due to Country X legal restrictions, the international settlement agreement specifies that G carries the transmission to a point outside the territory of Country X and that T carries the foreign-originating transmission from such point to the destined point in the United States. T, in turn, contracts out with another communications company, S, to transmit the U.S. portion of the communications. Tracing and identifying the endpoints of each transmission is not possible or practical. T does, however, keep records of termination fees received from G for terminating the foreign-originating calls.

(ii) *Analysis.* T derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, T can establish that T is paid to transmit, and bears the risk of transmitting, foreign-originating calls from a point in space or international water to a point in the United States using a reasonable method to establish the endpoints, assuming that this method is consistently applied. In this case, T can reasonably establish that T is paid to receive foreign-originating calls and terminate such calls in the United States based on the records of termination fees pursuant to an international settlement agreement. Under paragraph (h)(3)(ii)(B) of this section, a taxpayer derives income from international communications activity when the taxpayer is paid to transmit foreign-originating communications from space or international water to the United States. Thus, under paragraph (h)(3)(ii)(B) of this section, T

derives income from international communications. If, based on all the facts and circumstances, T could reasonably trace and identify the endpoints, then T would have to directly establish that each call originated in a foreign country. Assuming T is able to do so, the rest of the analysis in this *Example 7* remains the same. Under paragraph (h)(3)(iii) of this section, S derives income from U.S. communications activity because S is paid to transmit the communications between two U.S. points.

*Example 8. 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, even under the reasonable method rule of paragraph (h)(3) of this section.

(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 9. Reasonable methods—minutes of use data on long distance calling plans—(i) Facts.* B provides both domestic and international long distance services in a calling plan for a limited number of minutes for a set amount each month. Tracing and identifying the endpoints of each transmission is not possible or practical. B is, however, able to establish that the calling plan generated \$10,000 of revenue for 25,000 minutes based on reports derived from customer billing records. Based on minutes of use data in these reports, B is able to establish that of the total 25,000 minutes, 60 percent or 15,000 minutes were for U.S. long distance calls and 40 percent or 10,000 minutes were for international calls.

(ii) *Analysis.* B derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, B can establish the two points between which B is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish the endpoints, assuming that this method is consistently applied. In this case, B can reasonably establish that 60 percent of the income derived from the long distance calling plan is U.S. communications income and 40 percent is international communications income based on the minutes of use data derived from customer billing records to establish the endpoints of the communications. If, based on all the facts and circumstances, B could reasonably trace and identify the endpoints, then B would have to directly identify the endpoints between which B is paid to transmit the communications.

*Example 10. Reasonable methods—system design—(i) Facts.* D operates satellites which are designed to transmit signals through two separate ranges of signal frequencies (bands). Due to technological limitations, requirements, and practicalities, one band is designed to only transmit signals within the United States. The other band is designed to transmit signals between foreign countries and the United States. D cannot trace and identify the endpoints of each individual transmission. D does,



however, track the total transmission through each band and the total income derived from transmitting signals through each band.

(ii) *Analysis.* D derives communications income as defined in paragraph (h)(2) of this section. Based on all the facts and circumstances, D can establish the two points between which D is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish endpoints, assuming that this method is consistently applied. In this case, D can reasonably establish that income derived from transmissions through the first band is U.S. communications income and income derived from transmissions through the second band is international communications income based on the design of the bands to establish the endpoints of the communications.

*Example 11. Reasonable methods—port locations—(i) Facts.* X provides its customer, C, with a virtual private network (VPN) so that C's U.S. headquarter office can connect and communicate with offices in the United States, Country X, Country Y, and Country Z. Assume that the VPN is only for communications with the U.S. headquarter office. X cannot trace and identify the endpoints of each transmission. C pays X a set amount each month for the entire service, regardless of the magnitude of the usage or the geographic points between which C uses the service.

(ii) *Analysis.* X derives communications income as defined in paragraph (h)(2) of this section. Based on the facts and circumstances, X can establish the two points between which X is paid to transmit, and bears the risk of transmitting, the communications using a reasonable method to establish endpoints, assuming that this method is consistently applied. In this case, X can reasonably establish that one-fourth of the income derived from the VPN service is U.S. communications income and three-fourths is international communications income based on the location of the VPN ports to establish the endpoints of the communications.

*Example 12. 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 13. De minimis non-communications activity—(i) Facts.* The same facts as in *Example 12.* 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 14. 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 15. 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 16. 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), (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)(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 assess-

ment 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 December 27, 2006.

**PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101 paragraph (b) is amended by adding an entry to the table in numerical order, §§1.863-8 and 1.863-9, to read as follows:

*§602.101 OMB Control numbers.*

\* \* \* \* \*  
(b) \* \* \* \*

CFR part or section where identified and described	Current OMB control No.
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1.863-8 .....	1545-1718
1.863-9 .....	1545-1718
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Kevin M. Brown,  
*Acting Deputy Commissioner for Services and Enforcement.*

Approved December 21, 2006.

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

(Filed by the Office of the Federal Register on December 26, 2006, 8:45 a.m., and published in the issue of the Federal Register for December 27, 2006, 71 F.R. 77594)

**Section 6664.—Definitions and Special Rules**

*26 CFR 1.6664-1: Accuracy-related and fraud penalties; definitions, effective date and special rules.*

**T.D. 9309**

**DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Part 1**

**Qualified Amended Returns**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that state the rules relating to qualified amended returns by providing circumstances that end the period within which a taxpayer may file an amended return that constitutes a qualified amended return. The IRS uses qualified amended returns to determine whether an underpayment exists that is potentially subject to the accuracy-related penalty on underpayments. Among other things, these final regulations provide that the period for filing a qualified amended return is terminated once the IRS has served a John Doe summons on a third party with respect to the taxpayer's tax liability. In addition, for taxpayers who have claimed tax benefits from undisclosed listed transactions, the regulations provide that the period for filing a qualified amended return is terminated once the IRS requests information related to the transaction that is required

to be included on a list under section 6112 from any person who made a tax statement to or for the benefit of the taxpayer, or any person who gave material aid, assistance, or advice to the taxpayer. The regulations also provide that the date on which published guidance is issued announcing a settlement initiative for a listed transaction in which penalties, in whole or in part, are compromised or waived is an additional date by which a taxpayer must file a qualified amended return.

**DATES:** *Effective Date:* These regulations are effective January 9, 2007.

*Applicability Dates:* For dates of applicability, see §1.6664-1(b)(3).

**FOR FURTHER INFORMATION CONTACT:** Laura Urich Daly, 202-622-4940 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

## Background

This document contains Final Regulations under 26 CFR part 1 relating to qualified amended returns. Temporary regulations (T.D. 9186, 2005-1 C.B. 790) relating to qualified amended returns were published in the **Federal Register** (70 FR 10037) on March 2, 2005. A notice of proposed rulemaking (REG-122847-04, 2005-1 C.B. 804) cross-referencing the temporary regulations was published in the **Federal Register** (70 FR 10062) for the same day. A correction (70 FR 36345) and a correcting amendment (published as Announcement 2005-53, 2005-2 C.B. 258 [70 FR 36344]) to the regulations were published in the **Federal Register** on June 23, 2005, and a correction to the correction was published in the **Federal Register** (70 FR 43635) on July 28, 2005. No written or electronic comments were received from the public in response to the notice of proposed rulemaking and no public hearing was requested or held. The proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The revisions are discussed below.

## Explanation of Revisions

The final regulations clarify the applicability date of the regulations. Under the Special Rules section, the sentence in the proposed and temporary regulations regarding disclosure pursuant to §1.6011-4 was removed in these final regulations because it could be incorrectly interpreted to provide relief from the section 6707A penalty. These final regulations are not intended to have any effect upon the applicability of the section 6707A penalty. In addition, examples one, four, five, six, and seven in the proposed and temporary regulations were further clarified. Finally, example eight in the proposed and temporary regulations was removed as unnecessary.

No other substantive revisions were made to the proposed and temporary regulations or the corrections to those regulations. These final regulations do, however, include revisions to the table of contents to the regulations under section 6664.

## Special Analyses

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

## Drafting Information

The principal author of this regulation is Laura Urich Daly, Office of the Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division.

\* \* \* \* \*

## 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 1.6664-0 is amended by adding entries for §§1.6664-1(b)(3) and 1.6664-2(c)(3)(i), (ii) and (5), and revising the entry for §1.6664-2(c)(4) to read as follows:

*§1.6664-0 Table of contents.*

\* \* \* \* \*

*§1.6664-1 Accuracy-related and fraud penalties; definitions, effective date and special rules.*

\* \* \* \* \*

(b) \* \* \*

(3) Qualified amended returns.

*§1.6664-2 Underpayment.*

\* \* \* \* \*

(c) \* \* \*

(3) \* \* \*

(i) General rule.

(ii) Undisclosed listed transactions.

(4) Special rules.

(5) Examples.

\* \* \* \* \*

Par. 3. Section 1.6664-1 is amended by:

1. Revising the section heading.

2. Adding paragraph (b)(3).

The revision and addition read as follows:

*§1.6664-1 Accuracy-related and fraud penalties; definitions, effective date and special rules.*

\* \* \* \* \*

(b) \* \* \*

(3) *Qualified amended returns.* Sections 1.6664-2(c)(1), (c)(2), (c)(3)(i)(A), (c)(3)(i)(B), (c)(3)(i)(C), (c)(3)(i)(D)(2), (c)(3)(i)(E), and (c)(4) are applicable for amended returns and requests for administrative adjustment filed on or after March 2, 2005. Sections 1.6664-2(c)(3)(i)(D)(1) and (c)(3)(ii)(B) and (C) are applicable

for amended returns and requests for administrative adjustment filed on or after April 30, 2004. The applicability date for §1.6664-2(c)(3)(ii)(A) varies depending upon which event occurs under §1.6664-2(c)(3)(i). For purposes of §1.6664-2(c)(3)(ii)(A), the date described in §1.6664-2(c)(3)(i)(D)(1) is applicable for amended returns and requests for administrative adjustment filed on or after April 30, 2004. For purposes of §1.6664-2(c)(3)(ii)(A), the dates described in §1.6664-2(c)(3)(i)(A), (B), (C), (D)(2), and (E) are applicable for amended returns and requests for administrative adjustment filed on or after March 2, 2005. Section 1.6664-2(c)(1) through (c)(3), as contained in 26 CFR part 1 revised as of April 1, 2004 and as modified by Notice 2004-38, 2004-1 C.B. 949, applies with respect to returns and requests for administrative adjustment filed on or after April 30, 2004 and before March 2, 2005. Section 1.6664-2(c)(1) through (3), as contained in 26 CFR part 1 revised as of April 30, 2004, applies with respect to returns and requests for administrative adjustment filed before April 30, 2004.

#### §1.6664-1T [Removed]

Par. 4. Section 1.6664-1T is removed.

Par. 5. Section 1.6664-2(c) is revised to read as follows:

#### §1.6664-2 Underpayment.

\* \* \* \* \*

(c) *Amount shown as the tax by the taxpayer on his return*—(1) *Defined*. For purposes of paragraph (a) of this section, the *amount shown as the tax by the taxpayer on his return* is the tax liability shown by the taxpayer on his return, determined without regard to the items listed in paragraphs (b)(1), (2), and (3) of this section, except that it is reduced by the excess of—

(i) The amounts shown by the taxpayer on his return as credits for tax withheld under section 31 (relating to tax withheld on wages) and section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), as payments of estimated tax, or as any other payments made by the taxpayer with respect to a taxable year before filing the return for such taxable year, over

(ii) The amounts actually withheld, actually paid as estimated tax, or actually

paid with respect to a taxable year before the return is filed for such taxable year.

(2) *Effect of qualified amended return*. The *amount shown as the tax by the taxpayer on his return* includes an amount shown as additional tax on a qualified amended return (as defined in paragraph (c)(3) of this section), except that such amount is not included if it relates to a fraudulent position on the original return.

(3) *Qualified amended return defined*—(i) *General rule*. A *qualified amended return* is an amended return, or a timely request for an administrative adjustment under section 6227, filed after the due date of the return for the taxable year (determined with regard to extensions of time to file) and before the earliest of—

(A) The date the taxpayer is first contacted by the Internal Revenue Service (IRS) concerning any examination (including a criminal investigation) with respect to the return;

(B) The date any person is first contacted by the IRS concerning an examination of that person under section 6700 (relating to the penalty for promoting abusive tax shelters) for an activity with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly through the entity, plan or arrangement described in section 6700(a)(1)(A);

(C) In the case of a pass-through item (as defined in §1.6662-4(f)(5)), the date the pass-through entity (as defined in §1.6662-4(f)(5)) is first contacted by the IRS in connection with an examination of the return to which the pass-through item relates;

(D)(1) The date on which the IRS serves a summons described in section 7609(f) relating to the tax liability of a person, group, or class that includes the taxpayer (or pass-through entity of which the taxpayer is a partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) with respect to an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly.

(2) The rule in paragraph (c)(3)(i)(D)(1) of this section applies to any return on which the taxpayer claimed a direct or indirect tax benefit from the type of activity that is the subject of the summons, regardless of whether the summons seeks the production of information for the taxable period covered by such return; and

(E) The date on which the Commissioner announces by revenue ruling, revenue procedure, notice, or announcement, to be published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction. This rule applies only to a taxpayer who participated in the listed transaction and for the taxable year(s) in which the taxpayer claimed any direct or indirect tax benefits from the listed transaction. The Commissioner may waive the requirements of this paragraph or identify a later date by which a taxpayer who participated in the listed transaction must file a qualified amended return in the published guidance announcing the listed transaction settlement initiative.

(ii) *Undisclosed listed transactions*. An *undisclosed listed transaction* is a transaction that is the same as, or substantially similar to, a listed transaction within the meaning of §1.6011-4(b)(2) (regardless of whether §1.6011-4 requires the taxpayer to disclose the transaction) and was neither previously disclosed by the taxpayer within the meaning of §1.6011-4 or §1.6011-4T, nor disclosed under Announcement 2002-2, 2002-1 C.B. 304, (see §601.601(d)(2)(ii) of this chapter) by the deadline therein. In the case of an *undisclosed listed transaction* for which a taxpayer claims any direct or indirect tax benefits on its return (regardless of whether the transaction was a listed transaction at the time the return was filed), an amended return or request for administrative adjustment under section 6227 will not be a *qualified amended return* if filed on or after the earliest of—

(A) The dates described in paragraph (c)(3)(i) of this section;

(B) The date on which the IRS first contacts any person regarding an examination of that person's liability under section 6707(a) with respect to the undisclosed listed transaction of the taxpayer; or

(C) The date on which the IRS requests, from any person who made a tax statement to or for the benefit of the taxpayer or from any person who gave the taxpayer material aid, assistance, or advice as described in section 6111(b)(1)(A)(i) with respect to the taxpayer, the information required to be included on a list under section 6112 relating to a transaction that was the same as, or substantially similar to, the

undisclosed listed transaction, regardless of whether the taxpayer's information is required to be included on that list.

(4) *Special rules.* (i) A qualified amended return includes an amended return that is filed to disclose information pursuant to §1.6662-3(c) or §1.6662-4(e) and (f) even though it does not report any additional tax liability. See §1.6662-3(c), §1.6662-4(f), and §1.6664-4(c) for rules relating to adequate disclosure.

(ii) The Commissioner may by revenue procedure prescribe the manner in which the rules of paragraph (c) of this section regarding qualified amended returns apply to particular classes of taxpayers.

(5) *Examples.* The following examples illustrate the provisions of paragraphs (c)(3) and (c)(4) of this section:

*Example 1.* T, an individual taxpayer, claimed tax benefits on its 2002 Federal income tax return from a transaction that is substantially similar to the transaction identified as a listed transaction in Notice 2002-65, 2002-2 C.B. 690 (Partnership Entity Straddle Tax Shelter). T did not disclose his participation in this transaction on a Form 8886, "Reportable Transaction Disclosure Statement," as required by §1.6011-4. On June 30, 2004, the IRS requested from P, T's material advisor, an investor list required to be maintained under section 6112. The section 6112 request, however, related to the type of transaction described in Notice 2003-81, 2003-2 C.B. 1223 (Tax Avoidance Using Offsetting Foreign Currency Option Contracts). T did not participate in (within the meaning of §1.6011-4(c)) a transaction described in Notice 2003-81. T may file a qualified amended return relating to the transaction described in Notice 2002-65 because T did not claim a tax benefit with respect to the listed transaction described in Notice 2003-81, which is the subject of the section 6112 request.

*Example 2.* The facts are the same as in *Example 1*, except that T's 2002 Federal income tax return reflected T's participation in the transaction described in Notice 2003-81. As of June 30, 2004, T may not file a qualified amended return for the 2002 tax year.

*Example 3.* (i) Corporation X claimed tax benefits from a transaction on its 2002 Federal income tax return. In October 2004, the IRS and Treasury De-

partment identified the transaction as a listed transaction. In December 2004, the IRS contacted P concerning an examination of P's liability under section 6707(a) (as in effect prior to the amendment to section 6707 by section 816 of the American Jobs Creation Act of 2004 (the Jobs Act), Public Law 108-357 (118 Stat. 1418)). P is the organizer of a section 6111 tax shelter (as in effect prior to the amendment to section 6111 by section 815 of the Jobs Act) who provided representations to X regarding tax benefits from the transaction, and the IRS has contacted P about the failure to register that transaction. Three days later, X filed an amended return.

(ii) X's amended return is not a qualified amended return, because X did not disclose the transaction before the IRS contacted P. X's amended return would have been a qualified amended return if it was submitted prior to the date on which the IRS contacted P.

*Example 4.* The facts are the same as in *Example 3* except that, instead of contacting P concerning an examination under section 6707(a), in December 2004, the IRS served P with a John Doe summons described in section 7609(f) relating to the tax liability of participants in the type of transaction for which X claimed tax benefits on its return. X cannot file a qualified amended return after the John Doe summons has been served regardless of when, or whether, the transaction becomes a listed transaction.

*Example 5.* On November 30, 2003, the IRS served a John Doe summons described in section 7609(f) on Corporation Y, a credit card company. The summons requested the identity of, and information concerning, United States taxpayers who, during the taxable years 2001 and 2002, had signature authority over Corporation Y's credit cards issued by, through, or on behalf of certain offshore financial institutions. Corporation Y complied with the summons, and identified, among others, Taxpayer B. On May 31, 2004, before the IRS first contacted Taxpayer B concerning an examination of Taxpayer B's Federal income tax return for the taxable year 2002, Taxpayer B filed an amended return for that taxable year, that showed an increase in Taxpayer B's Federal income tax liability. Under paragraph (c)(3)(i)(D) of this section, the amended return is not a qualified amended return because it was not filed before the John Doe summons was served on Corporation Y.

*Example 6.* The facts are the same as in *Example 5*. Taxpayer B continued to maintain the offshore credit card account through 2003 and filed an original tax return for the 2003 taxable year claiming tax benefits attributable to the existence of the account. On

March 21, 2005, Taxpayer B filed an amended return for the taxable year 2003, that showed an increase in Taxpayer B's Federal income tax liability. Under paragraph (c)(3)(i)(D) of this section, the amended return is not a qualified amended return because it was not filed before the John Doe summons for 2001 and 2002 was served on Corporation Y, and the return reflects benefits from the type of activity that is the subject of the John Doe summons.

*Example 7.* (i) On November 30, 2003, the IRS served a John Doe summons described in section 7609(f) on Corporation Y, a credit card company. The summons requested the identity of, and information concerning, United States taxpayers who, during the taxable years 2001 and 2002, had signature authority over Corporation Y's credit cards issued by, through, or on behalf of certain offshore financial institutions. Taxpayer C did not have signature authority over any of Corporation Y's credit cards during either 2001 or 2002 and, therefore, was not a person described in the John Doe summons.

(ii) In 2003, Taxpayer C first acquired signature authority over a Corporation Y credit card issued by an offshore financial institution. Because Taxpayer C did not have signature authority during 2001 or 2002 over a Corporation Y credit card issued by an offshore financial institution, and was therefore not covered by the John Doe summons served on November 30, 2003, Taxpayer C's ability to file a qualified amended return for the 2003 taxable year is not limited by paragraph (c)(3)(i)(D) of this section.

\* \* \* \* \*

#### §1.6664-2T [Removed]

Par. 6. Section 1.6664-2T is removed.

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

Approved December 21, 2006.

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

(Filed by the Office of the Federal Register on January 8, 2007, 8:45 a.m., and published in the issue of the Federal Register for January 9, 2007, 72 F.R. 902)

# Part III. Administrative, Procedural, and Miscellaneous

## Description of Benefits Permitted to be Provided in Qualified Defined Benefit Plans

### Notice 2007-14

#### I. PURPOSE

The Treasury Department and the Internal Revenue Service are considering guidance under §§ 401(a) and 411 of the Internal Revenue Code to provide clarification regarding the types of benefits that are permitted to be provided in a qualified defined benefit plan. The guidance under consideration would initially be issued in the form of proposed regulations. This notice describes the guidance under consideration and requests comments on the issues raised in Part III of this notice.

#### II. BACKGROUND

Section 401(a) provides rules for qualified pension plans, profit-sharing plans, and stock bonus plans. Section 1.401-1(a)(2) of the Income Tax Regulations provides that a qualified pension plan (*i.e.*, a qualified defined benefit plan or money purchase pension plan) is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer to provide for the livelihood of the employees or their beneficiaries after the retirement of such employees through the payment of benefits. Under § 1.401-1(b)(1)(i), a qualified pension plan must be established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits for employees over a period of years, usually for life, after retirement.<sup>1</sup>

Retirement benefits in a qualified defined benefit plan usually are measured by, and based on, factors such as years of service and compensation. A qualified defined benefit plan (or other qualified pension plan) also may provide certain non-retirement benefits, such as disability ben-

efits and incidental death benefits. Under § 1.401-1(b)(1)(i), a qualified pension plan is not permitted to provide for the payment of benefits not customarily included in a pension plan, such as layoff benefits.<sup>2</sup>

Section 411(d)(6)(A) generally provides that a plan is treated as not satisfying the requirements of § 411 if the accrued benefit of a participant is decreased by a plan amendment. Section 411(d)(6)(B) provides that a plan amendment that has the effect of eliminating or reducing an early retirement benefit or a retirement-type subsidy, or eliminating an optional form of benefit, with respect to benefits attributable to service before the amendment is treated as impermissibly reducing accrued benefits. For a retirement-type subsidy, this protection applies only with respect to an employee who satisfies the preamendment conditions for the subsidy (either before or after the amendment).

Not all types of benefits permitted to be provided in a qualified defined benefit plan are protected from cutback under § 411(d)(6). In this respect, the 1984 Senate Finance Committee Report regarding section 301(a) of the Retirement Equity Act of 1984, Public Law 98-397 (98 Stat. 1426) (REA), which extended § 411(d)(6) anti-cutback protection to optional forms of benefit, early retirement benefits, and retirement-type subsidies, provides, in part:

The bill provides that the term “retirement-type subsidy” is to be defined by Treasury regulations. The committee intends that under these regulations, a subsidy that continues after retirement is generally to be considered a retirement-type subsidy. The committee expects, however, that a qualified disability benefit, a medical benefit, a social security supplement, a death benefit (including life insurance), or a plant shutdown benefit (that does not continue after retirement age) will not be considered a retirement-type subsidy. The committee expects that Treasury regulations will prevent the recharacterization of retirement-type

benefits as benefits that are not protected by the provision.

S. Rep. No. 98-575, at 30.

Sections 1.411(d)-3 and 1.411(d)-4, which were amended on August 12, 2005 (T.D. 9219, 2005-2 C.B. 538 [70 FR 47109]), provide rules relating to § 411(d)(6) protected benefits. Section 1.411(d)-4, Q&A-1(d), specifies that certain benefits, including ancillary benefits, are not protected from reduction or elimination under § 411(d)(6)(B). Section 1.411(d)-3 also includes rules relating to ancillary benefits. Section 1.411(d)-3(b)(3)(i) provides that § 411(d)(6) does not provide protection for benefits that are ancillary benefits, other rights and features, or any other benefits that are not described in § 411(d)(6).

Section 1.411(d)-3(g)(2) defines the term “ancillary benefit” as:

(1) a social security supplement under a defined benefit plan (other than a QSUPP as defined in § 1.401(a)(4)-12));

(2) a benefit payable under a defined benefit plan in the event of disability (to the extent that the benefit exceeds the benefit otherwise payable), but only if the total benefit payable in the event of disability does not exceed the maximum qualified disability benefit, as defined in § 411(a)(9);

(3) a life insurance benefit;

(4) a medical benefit described in § 401(h);

(5) a death benefit under a defined benefit plan other than a death benefit which is part of an optional form of benefit; or

(6) a plant shutdown benefit or other similar benefit in a defined benefit plan that does not continue past retirement age and does not affect the payment of the accrued benefit, but only to the extent that such plant shutdown benefit or other similar benefit is permitted in a qualified pension plan.

Section 1.411(d)-3(g) defines other key terms relating to the anti-cutback rules, including “retirement-type subsidy” and “retirement-type benefit.” Section 1.411(d)-3(g)(6)(iv) defines the term “retirement-type subsidy” as the excess, if

<sup>1</sup> The regulations under § 401(a) provide separate rules for profit-sharing plans and stock bonus plans. See § 1.401-1(a)(2) and (b)(1)(ii) and (iii).

<sup>2</sup> Section 1.401-1(b)(1)(i) specifies that other benefits not customarily included in a pension plan include benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in § 401(h) as defined in § 1.401-14(a)).

any, of the actuarial present value of a retirement-type benefit, over the actuarial present value of the accrued benefit commencing at normal retirement age or at actual commencement date, if later, with both such actuarial present values determined as of the date the retirement-type benefit commences. Section 1.411(d)-3(g)(6)(iii) defines the term “retirement-type benefit” as the payment of a distribution alternative with respect to an accrued benefit or the payment of any other benefit under a defined benefit plan (including a QSUPP as defined in § 1.401(a)(4)-12) that is permitted to be in a qualified pension plan, continues after retirement, and is not an ancillary benefit.

Under § 1.411(d)-4, Q&A-6, a plan may limit the availability of § 411(d)(6) protected benefits to employees who meet objective conditions that are ascertainable, specifically set forth in the plan, and not subject to employer discretion.<sup>3</sup> Q&A-6 provides examples of permissible objective conditions. Section 1.411(d)-4, Q&A-7 generally provides that a plan is not permitted to be amended to add objective conditions with respect to a § 411(d)(6) protected benefit that has already accrued. However, a plan amendment does not violate § 411(d)(6) to the extent that it applies to benefits that accrue after the amendment. Therefore, an amendment adding objective conditions to a § 411(d)(6) protected benefit is permitted with respect to benefits that accrue after the applicable amendment date.<sup>4</sup>

Section 411(a) provides that a qualified plan must provide that an employee’s right to his normal retirement benefit is nonforfeitable upon the attainment of normal retirement age, and also provides vesting requirements with respect to an employee’s accrued benefit. Under § 411(a)(9), the term “normal retirement benefit” is defined as the greater of the early retirement benefit under the plan or the benefit under the plan commencing at normal retirement age. Section 411(b)(1) provides anti-backloading rules governing the accrual of benefits under a defined benefit plan, to ensure that the minimum vesting rules of § 411(a)

are not circumvented through a plan formula under which accruals are inappropriately deferred.

Section 905(b) of the Pension Protection Act of 2006 (“PPA ’06), enacted on August 17, 2006, added § 401(a)(36), which provides that, for plan years beginning after December 31, 2006, a pension plan will not fail to qualify under § 401(a) solely because the plan provides that a distribution may be made to an employee who has attained age 62 and who is not separated from employment at the time of the distribution.

### III. GUIDANCE UNDER CONSIDERATION

Treasury and the Service have become concerned that certain qualified defined benefit plans may include nontraditional benefits that are not subject to the protections of § 411 and other qualification rules of § 401(a). Examples of the types of benefits for which this concern arises include: (1) benefits that are payable only upon the involuntary termination of an employee or in other limited circumstances that are unrelated to retirement; and (2) benefits that could exceed the amount of the accrued benefit payable under the plan. If these benefits are contingent on future events that are not reasonably and reliably predictable on an actuarial basis, it is difficult to determine compliance with the incidental benefit requirements.<sup>5</sup> Moreover, there may be a risk that, in effect, if the contingent event on which the benefit is conditioned occurs, such a benefit could become a substantial or even the primary benefit that plan participants expect to receive. Such benefits also may not be the types of benefits that have been customarily included in qualified pension plans. Benefits payable only upon an employee’s involuntary separation from service also raise questions regarding whether the availability of the benefits is based on conditions that are within the employer’s control, and whether such benefits circumvent the vesting and anti-backloading protections of § 411, as well as the defi-

nately determinable benefits requirement of § 401(a). In addition, such benefits may not be among the type of benefits that are intended to receive the tax benefits generally applicable to qualified plan benefits.

Treasury and the Service believe that guidance to clarify the application of the requirements of §§ 401(a) and 411 to these types of benefits may be appropriate in light of the regulations under § 411(d)(6) that were issued in 2005. The § 1.411(d)-3 definitions of an ancillary benefit, a retirement-type benefit, and a retirement-type subsidy depend, in part, on whether a benefit is permitted to be provided in a qualified defined benefit plan. However, current guidance does not directly address whether certain benefits, such as benefits which are similar to plant shutdown benefits that do not continue after retirement or benefits payable solely upon involuntary separation, are permitted to be provided in a qualified pension plan. Thus, Treasury and the Service are considering whether to propose guidance that would clarify the types of benefits that are permitted to be provided in qualified defined benefit plans.

The guidance under consideration may include the following:

A. *Permitted benefits.* The guidance might provide that, in addition to the payment of retirement-type benefits (including retirement-type subsidies), the only benefit payments that are permitted to be provided under a qualified defined benefit plan are the payment of the ancillary benefits specifically identified in § 1.411(d)-3(g)(2).

B. *Plant shutdown benefits and similar ancillary benefits.* With respect to a plant shutdown benefit, the guidance might require that the benefit be payable as a result of an objectively defined plant shutdown event, such as an event that requires notice under the Worker Adjustment and Retraining Notification Act of 1988 (WARN), 29 U.S.C. section 2102. For benefits that are similar to plant shutdown benefits and that do not continue past retirement age, the guidance might set forth the extent to which there are any such “similar benefits,” as described in

<sup>3</sup> A plan provision that permits an employer to deny a participant a § 411(d)(6) protected benefit for which the participant is otherwise eligible through the exercise of discretion violates the requirements of § 411(d)(6). See § 1.411(d)-4, Q&A-4. Similarly, pursuant to § 1.411(d)-4, Q&A-6(b), a plan cannot condition the availability of § 411(d)(6) protected benefits on objective conditions that are within the employer’s discretion.

<sup>4</sup> The term *applicable amendment date* means the later of the effective date of a plan amendment or the date the amendment is adopted. See § 1.411(d)-3(g)(4).

<sup>5</sup> In the case of benefits which are contingent on events that are reasonably and reliably predictable on an actuarial basis (e.g., death), the probability that those contingencies will occur is taken into account in determining whether retirement benefits are the primary benefit under the plan (i.e., whether nonretirement benefits provided under the plan are merely incidental).

§ 1.411(d)-3(g)(2)(vi), that are permitted to be provided in a qualified defined benefit plan.

The guidance also might clarify that an ancillary plant shutdown benefit, as described in § 1.411(d)-3(g)(2)(vi), is permitted to be provided in a qualified defined benefit plan only if the amount payable in any year prior to retirement does not exceed the amount payable annually under the participant's accrued benefit expressed as an annual benefit commencing at normal retirement age and that the benefit may not be paid in a shorter or longer alternative form of payment. Under such a rule, for example, if a plan participant who is below the plan's normal retirement age of 65 had an accrued benefit payable as a life annuity at age 65 of \$1,000 a month, the plan would be permitted to provide an ancillary plant shutdown benefit payable as a temporary annuity in an amount up to \$1,000 a month. In such a case, the ancillary plant shutdown benefit would be paid to the plan participant up until the annuity starting date for payment of the participant's accrued benefit under the plan (e.g., age 65 or some earlier age when the participant commences payment of the participant's accrued benefit in the form of a qualified joint and survivor annuity or elects an alternative optional form). This illustration of an ancillary plant shutdown benefit is different from a subsidized early retirement benefit payable on the occurrence of a plant shutdown.<sup>6</sup>

*C. Contingent accruals and early retirement benefits.* The guidance might also provide that, except for the payment of the accrued benefit in an optional form, a retirement-type benefit (and thus a retirement-type subsidy) is permitted to be provided in a qualified defined benefit plan only if the amount of the benefit is no greater than the unreduced accrued benefit provided under the plan. The guidance might also clarify the extent to which additional accruals are permitted, taking into account the backloading and vesting rules under § 411, if those accruals arise by reason of an event other than attainment of a specified age, performance of service, receipt or derivation of compensation, or the occurrence of death or disability (e.g., if those additional accruals arise upon invol-

untary termination of employment). The guidance also might clarify the extent to which early retirement benefits (i.e., benefits payable before normal retirement age, but after severance from employment, that are not ancillary benefits) payable as a result of a plant shutdown event, an involuntary termination of employment, or another event similarly under the control of the employer are permitted to be provided in a qualified defined benefit plan.

#### IV. EFFECTIVE DATE

It is anticipated that the guidance under consideration in this notice would be prospective. No implication is intended that the consideration of these issues affects the application of current law.

#### V. COMMENTS REQUESTED

Comments regarding the guidance under consideration described in Part III of this notice are requested. Of particular interest to Treasury and the Service are comments regarding the extent to which qualified defined benefit plans currently offer the types of benefits described in Part III of this notice, and comments regarding any appropriate transition rules that should be included in the guidance.

Written comments should be submitted by May 13, 2007. Send submissions to CC:PA:LPD:PR, (Notice 2007-14), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044. Comments may also be hand delivered Monday through Friday between the hours of 8:30 a.m. and 4:00 p.m. to: Internal Revenue Service, CC:PA:LPD:PR, (Notice 2007-14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Alternatively, comments may be submitted via the Internet at [notice.comments@irs.counsel.treas.gov](mailto:notice.comments@irs.counsel.treas.gov) (Notice 2007-14). All comments will be available for public inspection.

#### DRAFTING INFORMATION

The principal authors of this notice are Pamela R. Kinard and Preston Rutledge of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Gov-

ernment Entities) and Kathleen Herrmann of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, contact Ms. Kinard at (202) 622-6060 or Mr. Rutledge at (202) 622-6090 (not toll-free numbers).

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## Closing Agreements for Certain Life Insurance and Annuity Contracts that Fail to Meet the Requirements of Section 817(h), 7702 or 7702A (As Applicable)

### Notice 2007-15

#### SECTION 1. PURPOSE

This notice requests comments on how the Internal Revenue Service (the Service) might improve the procedures for obtaining closing agreements to correct inadvertent failures of life insurance or annuity contracts to satisfy the requirements of §§ 817(h), 7702 or 7702A of the Internal Revenue Code (Code), as applicable. This notice also provides four draft model closing agreements for comment.

#### SECTION 2. BACKGROUND

.01 *Qualification as a life insurance contract under § 7702.* (1) Section 7702 defines the term "life insurance contract" for all purposes of the Code. Section 7702(a) provides that a "life insurance contract" is any contract that is a life insurance contract under the applicable law, but only if such contract either (1) meets the cash value accumulation test of § 7702(b), or (2) meets the guideline premium requirements of § 7702(c) and falls within the cash value corridor of § 7702(d). (For flexible premium life insurance contracts issued before January 1, 1985, § 101(f)(1) provides that any amount paid by reason of death of the insured under a flexible premium life insurance contract issued before January 1, 1985, is excluded from gross income only if, under the contract, the sum of the premiums does not exceed the guideline premium limitation as of such time.)

<sup>6</sup> An example of a subsidized early retirement benefit is the unreduced early retirement benefit described in *Bellas v. CBS, Inc.*, 221 F.3d 517 (3d. Cir. 2000), cert. denied, 531 U.S. 1104 (2001) (holding that an early retirement benefit that is more valuable than an actuarially reduced normal retirement benefit and that is payable on occurrence of an unpredictable contingent event is a retirement-type subsidy, and therefore is protected under § 204(g) of the Employee Retirement Income Security Act of 1974).



(2) Charges for benefits that are qualified additional benefits (QABs) within the meaning of § 7702(f)(5) are subject to the expense charge rule of § 7702(C)(3)(B)(ii) for purposes of determining whether a contract satisfies the cash value accumulation test or the guideline premium requirements, as applicable. Section 7702(b)(2)(B); Rev. Rul. 2005–6, 2005–1 C.B. 471.

(3) Section 7702(f)(8) provides that if a taxpayer establishes to the satisfaction of the Secretary that the requirements of § 7702(a) were not met due to reasonable error, and reasonable steps are being taken to remedy that error, the Secretary may waive such failure.

(4) Section 7702(g)(1)(A) provides that if at any time a contract that is a life insurance contract under the applicable law does not meet the definition of a life insurance contract under § 7702(a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year. Further, § 7702(g)(1)(C) provides that if, during any taxable year of the policyholder, a contract that is a life insurance contract under the applicable law ceases to meet the definition of life insurance contract under § 7702(a), the income on the contract for all prior taxable years is treated as received or accrued during the taxable year in which such cessation occurs.

*.02 Diversification requirement for variable contracts.* (1) Section 817(d) defines the term “variable contract” to mean a contract that (1) provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to state law or regulation, is segregated from the general asset accounts of the company, and (2) provides for the payment of annuities, or is a life insurance contract, or provides for funding of insurance on retired lives. In the case of an annuity contract or a contract that provides funding of insurance on retired lives, the amounts paid in or the amounts paid out are required to reflect the investment return and the market value of the segregated asset account. In the case of a life insurance contract, the amount of the death benefit (or the period of coverage) must be adjusted on the basis of the investment return and the market value of the segregated asset account.

(2) Section 817(h) provides that for purposes of §§ 72 and 7702(a), a variable contract (other than a pension plan contract) that is otherwise described in § 817, and that is based on a segregated asset account, is not treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by such account are not adequately diversified.

(3) Section 1.817–5(a)(2) of the Income Tax Regulations provides that the investments of a segregated asset account are treated as satisfying the diversification requirements of § 1.817–5(b) for one or more periods if (1) the issuer or holder of a variable contract based on the account shows that the failure to satisfy the diversification requirements was inadvertent; (2) the investments of the account satisfy the diversification requirements within a reasonable time after discovery of the failure; and (3) the issuer or holder agrees to make such adjustments or pay such amounts as the Commissioner may require.

*.03 Treatment of Modified Endowment Contracts.* (1) Section 7702A defines a modified endowment contract (MEC) as a contract that meets the requirement of § 7702 but fails to meet the 7-pay test of § 7702A(b), or that is received in exchange for a contract that is a MEC. Under § 7702A(b), a contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the net level premiums that would have been paid on or before that time if the contract provided for paid-up future benefits after the payment of seven level annual premiums.

(2) Section 7702A(c)(1) provides that determinations under the 7-pay test are made by applying the rules of §§ 7702(b)(2) and 7702(e), with modifications. Under this provision, charges for QABs are accounted for under the expense charge rule of § 7702(c)(3)(B)(ii).

(3) Section 72(e)(10) provides that a MEC is subject to the rules of § 72(e)(2)(B) (which taxes non-annuity distributions on an income-out-first basis) and § 72(e)(4)(A) (which generally treats loans, assignments, or pledges of any portion of the value of a MEC as non-annuity distributions). Further, under § 72(v), an amount received under a MEC may be subject to a 10% additional tax.

*.04 Authority to enter into closing agreements.* Under the authority of § 7121, the Service may enter into a closing agreement with a taxpayer in respect of any internal revenue tax for any taxable period.

### SECTION 3. EXISTING CORRECTION PROCEDURES

To remedy the significant unforeseen tax consequences for holders of contracts that fail these provisions, the Service provides procedures for issuers of these failed contracts to enter into closing agreements with the Service.

(1) In Rev. Rul. 91–17, 1991–1 C.B. 190, *amplified by* Rev. Proc. 92–25, 1992–1 C.B. 741, an insurance company issued contracts that qualified as life insurance, endowment, and annuity contracts under the applicable law, but otherwise failed to meet the definition of life insurance contracts under § 7702(a) or the diversification requirements of § 817(h). The ruling concludes that the income on the contracts is a non-periodic distribution for which the insurance company is subject to certain recordkeeping, reporting, withholding and deposit obligations. In addition, if the company’s failure to meet those obligations was not due to reasonable cause, the company could be subject to various penalties under the Code. Rev. Rul. 91–17 provides that the Service will waive civil penalties for failure to satisfy the reporting, withholding, and deposit requirements for income deemed received under § 7702(g) if (a) the insurance company requests and receives a waiver of the failure to meet the definition of a life insurance contract pursuant to § 7702(f)(8); (b) the insurance company satisfies the conditions of § 1.817–5(a)(2)(i)–(iii) of the regulations; or (c) the insurance company requests and, in a timely manner, executes a closing agreement under which the company agrees to pay an amount based on the amount of tax that would have been owed by the policyholders if they were treated as receiving the income on the contracts, and any interest with regard to such tax. Notice 99–48, 1999–2 C.B. 429, provides the tax rates to be used to compute the amount of tax that would have been owed by the policyholders if they were treated as receiving the income on the contracts.

(2) Rev. Proc. 92–25, 1992–1 C.B. 741, provides a procedure by which an issuer of a variable contract seeking relief under § 1.817–5(a)(2) of the regulations may request to enter into a closing agreement with the Service. Under the procedure, an issuer of the failed contracts may remedy the failure by paying an amount based on the tax and interest that the policyholder would be required to pay. A model closing agreement was provided.

(3) Rev. Proc. 2001–42, 2001–2 C.B. 212, *modified and amplified* by Rev. Proc. 2007–19, page 515, this Bulletin, provides the procedure by which an issuer may remedy an inadvertent non-egregious failure to comply with the MEC rules under § 7702A. Under this procedure, an issuer may remedy such a failure by paying an amount based on the overages on the unintended MECs and the tax and interest that the policyholder would be required to pay on those overages, based on proxy earnings and tax rates. A model closing agreement was provided. Rev. Proc. 2007–19 simplified Rev. Proc. 2001–42 by making it easier for issuers to locate indices used to compute proxy earnings rates, and by permitting electronic filing of templates that are required under the procedure.

(4) Rev. Rul. 2005–6, 2005–1 C.B. 471, provides that for purposes of determining whether a contract qualifies as a life insurance contract under § 7702 or as a MEC under § 7702A, charges for QABs are taken into account under the expense charge rule of § 7702(c)(3)(B)(ii). The revenue ruling provides three alternatives for issuers of life insurance contracts that do not account for QABs under the expense charge rule. Alternative C, which applies after February 7, 2006, provides that an issuer whose compliance system does not properly account for charges for QABs may request a closing agreement under certain terms. Under this alternative, the amount required to be paid is based on the number of contracts for which relief is requested.

#### SECTION 4. DRAFT MODEL CLOSING AGREEMENTS

Four draft model closing agreements are set forth in Exhibits A through D. Exhibit A would correct inadvertent failures to satisfy the guideline premium require-

ments of § 7702. Exhibit B would correct failures to satisfy the requirements of § 7702 or the requirements of § 7702A due to improper accounting for charges for QABs. *See* Rev. Rul. 2005–6, Alternative C. Exhibits C and D would update the model closing agreements previously provided in Rev. Proc. 2001–42 (for inadvertent MECs) and Rev. Proc. 92–25 (for inadvertent failures to satisfy the diversification requirements of § 817(h)).

#### SECTION 5. REQUEST FOR COMMENTS

.01 *In general.* Because additional changes to the existing procedures may be warranted, the Service invites comments on how the various correction procedures in general may be simplified.

.02 *Draft model closing agreements.* The Service requests comments on the model closing agreements that are included in this notice as Exhibits A, B, C, and D. The Service will consider all comments before issuing final model closing agreements.

.03 *Other matters.* In addition to the general matters described in section 5.01 and 5.02, the Service requests comments in the following specific areas:

(a) Under what circumstances, if any, should the Service retain the discretion to negotiate different terms and conditions for failures that otherwise would be covered by the final model closing agreement?

(b) Would additional model closing agreements be useful to remedy other failures involving life insurance or annuity contracts, such as the failure of a life insurance contract to satisfy the cash value accumulation test of § 7702(b), or the failure of an annuity contract to contain the distribution provisions required under § 72(s)? If so, please describe the specific failures.

(c) Could the process for obtaining a waiver of reasonable errors under § 7702(f)(8) be simplified? If so, please describe.

(d) Do the three alternatives set forth in Rev. Rul. 2005–6 provide an appropriate model for remedies of other errors under § 7702 that would have been considered reasonable within the meaning of § 7702(f)(8) before, but not after, the Service published guidance on the underlying legal issue?

(e) Could the amounts that are required to be paid under the model closing agreements be determined more simply, without altering the incentives already in place for complying with §§ 72, 817(h), 7702 and 7702A and for coming forward voluntarily once errors are discovered? For example, do the existing procedures require issuers to produce information not otherwise generated in the normal course of administering the contracts? Are there circumstances in which the amount paid under the model closing agreements would more appropriately be determined based on factors other than total income on the contract?

(f) Do the amounts required to be paid under the model closing agreements strike an appropriate balance between making the government whole for the tax that otherwise would be due, and encouraging voluntary compliance with the underlying provisions once an error is discovered? If lesser amounts might be appropriate in some circumstances, what are those circumstances and how should those amounts be limited?

(g) Should each model closing agreement contain language to the effect the agreement is null and void if the taxpayer does not remit the required payment and undertake the required corrective actions within the time frames set forth in the agreement? Do the time frames in the draft model closing agreements allow taxpayers enough time to satisfy their obligations under those agreements?

.04 *Address for submitting comments.* Written comments on the issues addressed in this notice may be submitted to the Office of the Associate Chief Counsel (Financial Institutions and Products), Attention: Melissa S. Luxner (Notice 2007–15), room 3552, CC:FIP:4, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to [Notice.Comments@irs.counsel.treas.gov](mailto:Notice.Comments@irs.counsel.treas.gov). The Service requests any comments by June 12, 2007.

#### SECTION 6. PENDING REQUESTS FOR CLOSING AGREEMENTS

The Service will continue to process closing agreements under §§ 72, 817(h), 7702 and 7702A under existing procedures until those procedures are modified

The principal author of this notice is Melissa S. Luxner of the Office of Associate Chief Counsel (Financial In-

EXHIBIT A

Effective as of date executed by Internal Revenue Service \_\_\_\_\_

CLOSING AGREEMENT AS TO FINAL DETERMINATION COVERING SPECIFIC MATTERS UNDER SECTION 7702

THIS CLOSING AGREEMENT ("Agreement") is made pursuant to § 7121 of the Internal Revenue Code (the "Code") by and between [Insert Taxpayer Name, Address and EIN] ("Taxpayer") and the Commissioner of Internal Revenue (the "Service").

WHEREAS,

A. Taxpayer is the issuer of one or more contracts that were intended to qualify as life insurance contracts under § 7702.

B. Pursuant to Rev. Rul. 91-17, 1991-1 C.B. 190, amplified by Rev. Proc. 92-25, 1992-1 C.B. 741, as supplemented by Notice 99-48, 1999-2 C.B. 429, the Service under certain circumstances will waive civil penalties for failure of a taxpayer to satisfy the reporting, withholding and deposit requirements for income received or deemed received under § 7702(g).

C. By letter dated [Insert date] Taxpayer submitted to the Service, pursuant to Rev. Proc. 2006-1, 2006-1 I.R.B. 1 [or successor Rev. Proc., if applicable], a request for this Agreement covering [Insert number] of Taxpayer's life insurance contracts identified on Exhibit A attached to this Agreement (the "Contracts").

D. Taxpayer intended that each of the Contracts meet the definition of life insurance contract under § 7702. For each Contract, however, Taxpayer accepted and retained premiums that exceeded the Contract's guideline premium limitations under § 7702(c)(2) [or § 101(f), if applicable]. As a result, each of the Contracts identified on Exhibit A failed to satisfy the requirements of § 7702.

E. The Service has determined that the errors described in C above which caused the Contracts to fail to satisfy the requirements of § 7702 were not reasonable errors within the meaning of § 7702(f)(8) [or § 101(f)(3)(H), if applicable], but are eligible for relief under Rev. Rul. 91-17.

F. Taxpayer represents to the Service that:

- (1) With respect to Contracts under which the "death benefit," within the meaning of Notice 99-48, 1999-2 C.B. 429, is less than \$50,000, the aggregate "income on the contract," within the meaning of § 7702(g)(1), through [Insert date], is \$[insert amount]. The aggregate "income on the contract" for each year of failure is:

Table with 2 columns: Year, Amount. Includes a Total row at the bottom.

- (2) With respect to Contracts under which the "death benefit," within the meaning of Notice 99-48, is equal to or exceeds \$50,000 but is less than \$180,000, the aggregate "income on the contract," within the meaning of § 7702(g)(1), through [Insert date], is \$ [insert amount]. The aggregate "income on the contract" for each year of failure is:

Table with 2 columns: Year, Amount. Includes a Total row at the bottom.

- (3) With respect to Contracts under which the “death benefit,” within the meaning of Notice 99–48, is equal to or exceeds \$180,000, the aggregate income on the contract,” within the meaning of § 7702(g)(1), through *[Insert date]*, is \$ *[insert amount]*. The aggregate “income on the contract” for each year of failure is:

<u>Year</u>	<u>Amount</u>
	<hr/>
	Total

G. With respect to Contracts under which the death benefit is less than \$50,000, the tax (determined at a tax rate of 15 percent) that would have been owed by the Contract holders if they were treated as receiving the income on the Contracts set forth in E(1) above is \$ *[insert amount]*. With respect to Contracts under which the death benefit is equal to or exceeds \$50,000 but is less than \$180,000, the tax (determined at a rate of 28 percent) that would have been owed by the Contract holders if they were treated as receiving the income on the Contracts set forth in E(2) above is \$ *[insert amount]*. With respect to Contracts under which the death benefit is equal to or exceeds \$180,000, the tax (determined at a tax rate of 36 percent) that would have been owed by the Contract holders if they were treated as receiving the income on the Contracts set forth in E(3) above is \$ *[insert amount]*.

The total tax that would have been owed by the Contract holders if they were treated as receiving the income on the Contracts is \$ *[insert amount]*. Interest on the total tax through *[Insert date]* is \$ *[insert amount]*. The two amounts total \$ *[insert amount]*.

H. To ensure that the Contracts qualify as life insurance contracts under § 7702(a), Taxpayer and the Service have entered into this Agreement.

NOW THEREFORE IT IS HEREBY FURTHER DETERMINED AND AGREED BETWEEN TAXPAYER AND THE SERVICE AS FOLLOWS:

1. In consideration for the agreement of the Service as set forth in Section 2 below, Taxpayer agrees as follows:

(A) Taxpayer will pay the Service the amount of \$ *[insert amount]* at the time and in the manner described in Section 3 below.

(B) The amount paid pursuant to Section 1(A) above is not deductible, nor is such amount refundable, subject to credit or offset, or otherwise recoverable from the Service.

(C) For purposes of Taxpayer’s complying with its reporting and withholding obligations under the Code,

(i) neither the investment in the contract for purposes of § 72, nor the premiums paid for purposes of § 7702 *[or § 101(f), if applicable]*, on any Contract can be increased by any portion of the amount set forth in Section 1(A) above. If any such increases are made, they are entitled to no effect.

(ii) neither the investment in the contract for purposes of § 72, nor the premiums paid, for purposes of § 7702 *[or § 101(f), if applicable]*, on any Contract can be increased by any portion of the amount which Taxpayer represents to be the income on the contract for all of the Contracts in the aggregate. If any such increases are made, they are entitled to no effect.

(D) With respect to each Contract that is in force on the effective date of this Agreement, to the extent necessary in order to bring such Contract into compliance with § 7702 *[or § 101(f), if applicable]*:

(i) If the sum of the premiums paid as of the effective date of this Agreement exceeds the guideline premium limitation as of such date, Taxpayer will take the following corrective action:

(a) Increase the death benefit to not less than an amount that will ensure compliance with § 7702 *[or § 101(f), if applicable]*, or

(b) Refund to the Contract holder the amount of such excess, with interest at the Contract’s interest crediting rate; or

(ii) If the sum of the premiums paid as of the effective date of this Agreement does not exceed the guideline premium limitation as of such date, Taxpayer will take no corrective action.

(E) With respect to any Contract which terminated by reason of the death of the insured and (i) prior to the date this Agreement is executed by the Service and Taxpayer and (ii) at a time when the premiums paid exceeded the guideline premium limitation for the Contract, Taxpayer will pay the Contract holder or the Contract holder’s estate such excess, with interest at the Contract’s interest crediting rate.

2. In consideration of the agreement of Taxpayer set forth in Section 1 above, the Service agrees as follows:

- (A) To treat each Contract that is still in force as of the effective date of this Agreement as having satisfied the requirements of § 7702 [or § 101(f), if applicable] during the period from the date of issuance of the Contract through and including the later of (i) the date of the execution of this Agreement by the Service; or (ii) the date of any corrective action described in Section 1(D) above;
- (B) To treat each Contract that terminated prior to the effective date of this Agreement as having satisfied the requirements of § 7702 [or § 101(f), if applicable] during the period from date of issuance of the Contract through and including the date of the Contract’s termination;
- (C) To treat the failures described above, and any corrective action described in Section 1(D) or 1(E) above, as having no effect on the date the Contract was issued or entered into;
- (D) To treat any amount paid prior to the effective date of this Agreement to any beneficiary under a Contract by reason of the death of the insured as paid under a life insurance contract for purposes of the exclusion from gross income under § 101(a)(1);
- (E) To waive civil penalties for failure of Taxpayer to satisfy the reporting, withholding, or deposit requirements for income deemed received by Contract holders under § 7702; and
- (F) To treat no portion of the amount described in Section 1(A) above as income to the Contract holders.

3. Any action required of Taxpayer in Section 1(D) or 1(E) above shall be taken by Taxpayer no later than ninety (90) days after the date of execution of this Agreement by the Service. Payment of the amount described in Section 1(A) above shall be made within thirty (30) days after the date of execution of this Agreement by the Service by check payable to the “United States Treasury,” delivered together with a copy of this executed Agreement to Internal Revenue Service, Receipt and Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

4. This Agreement is, and shall be construed as being, for the benefit of Taxpayer. Contract holders covered by this Agreement are intended beneficiaries of this Agreement. This Agreement shall not be construed as creating any liability of Taxpayer to the Contract holders.

5. Neither the Service nor Taxpayer shall endeavor by litigation or other means to attack the validity of this Agreement.

6. This Agreement may not be cited or relied upon as precedent in the disposition of any other matter.

NOW THIS CLOSING AGREEMENT FURTHER WITNESSETH, that the Service and Taxpayer mutually agree that the matters so determined shall be final and conclusive, except as follows:

1. The matter to which this Agreement relates may be reopened in the event of fraud, malfeasance, or misrepresentation of material facts set forth herein.

2. This Agreement is subject to sections of the Code that expressly provide that effect be given to their provisions notwithstanding any other law or rule of law except § 7122.

3. This Agreement is subject to any legislation enacted subsequent to the date of execution hereof if the legislation provides that it is effective with respect to closing agreements.

IN WITNESS WHEREOF, the parties have subscribed their names to these presents in triplicate.

*[Insert Taxpayer name]*

Date Signed: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

COMMISSIONER OF INTERNAL REVENUE

Date Signed: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

EXHIBIT B

Effective as of date executed by Internal  
Revenue Service \_\_\_\_\_

CLOSING AGREEMENT AS TO FINAL DETERMINATION  
COVERING SPECIFIC MATTERS  
UNDER REV. RUL. 2005-6

THIS CLOSING AGREEMENT (“Agreement”) is made pursuant to § 7121 of the Internal Revenue Code (the “Code”) by and between *[Insert Taxpayer Name, Address and EIN]* (“Taxpayer”) and the Commissioner of Internal Revenue (the “Service”).

WHEREAS,

A. Taxpayer is the issuer of one or more contracts that were intended to qualify as life insurance contracts under § 7702 and that provided qualified additional benefits (QABs) within the meaning of § 7702(f)(5).

B. Pursuant to Rev. Rul. 2005-6, 2005-1 C.B. 471, the Service under certain circumstances will waive civil penalties for failure of a taxpayer to satisfy the reporting, withholding and deposit requirements for income received or deemed received under § 7702(g).

C. By letter dated *[Insert date]* Taxpayer submitted to the Service, pursuant to Rev. Proc. 2006-1, 2006-1 I.R.B. 1 *[or successor Rev. Proc., if applicable]*, a request for this Agreement covering *[Insert number]* of Taxpayer’s life insurance contracts identified on Exhibit A attached to this Agreement (the “Contracts”).

D. Taxpayer intended that each of the Contracts meet the definition of a life insurance contract under § 7702 and not be a modified endowment contract (MEC) within the meaning of § 7702A. Taxpayer, however, maintained a compliance system for the contracts that did not account properly for charges for qualified additional benefits (QABs) under § 7702(c)(3)(B)(ii). As a result, the Contracts identified in Exhibit A failed to satisfy the requirements of § 7702 or § 7702A, as applicable.

E. The Service has determined that the errors described in C above qualify the issuer for the remedy described in Rev. Rul. 2005-6.

F. To ensure that the Contracts qualify as life insurance contracts under § 7702(a), Taxpayer and the Service have entered into this Agreement.

NOW THEREFORE IT IS HEREBY FURTHER DETERMINED AND AGREED BETWEEN TAXPAYER AND THE SERVICE AS FOLLOWS:

1. In consideration for the agreement of the Service as set forth in Section 2 below, Taxpayer agrees as follows:
  - (A) To pay the Service the amount of \$ *[insert amount]* at the time and in the manner described in Section 3 below.
  - (B) The amount paid pursuant to Section 1(A) above is not deductible, nor is such amount refundable, subject to credit or offset, or otherwise recoverable from the Service.
  - (C) For purposes of Taxpayer’s complying with its reporting and withholding obligations under the Code,
    - (i) neither the investment in the contract for purposes of § 72, nor the premiums paid for purposes of § 7702, on any Contract can be increased by any portion of the amount set forth in Section 1(A) above. If any such increases are made, they are entitled to no effect.
    - (ii) neither the investment in the contract for purposes of § 72, nor the premiums paid, for purposes of § 7702, on any Contract can be increased by any portion of the amount which Taxpayer represents to be the income on the contract for all of the Contracts in the aggregate. If any such increases are made, they are entitled to no effect.
  - (D) With respect to each Contract that is in force on the effective date of this Agreement, to the extent necessary in order to bring such Contract into compliance with § 7702:
    - (i) If the sum of the premiums paid as of the effective date of this Agreement exceeds the amount necessary to keep the contracts in compliance with the requirements of § 7702, Taxpayer will take the following corrective action:
      - (a) Increase the death benefit to not less than an amount that will ensure compliance with § 7702, or
      - (b) Refund to the Contract holder the amount of such excess, with interest at the Contract’s interest crediting rate; or

- (ii) If the sum of the premiums paid as of the effective date of this Agreement does not exceed the amount necessary to keep the contracts in compliance with the requirements of § 7702, Taxpayer will take no corrective action.
- (E) With respect to any Contract which terminated by reason of the death of the insured and (i) prior to the date this Agreement is executed by the Service and Taxpayer and (ii) at a time when the premiums paid exceeded the guideline premium limitation for the Contract, Taxpayer will pay the Contract holder or the Contract holder's estate such excess, with interest at the Contract's interest crediting rate.

2. In consideration of the agreement of Taxpayer set forth in Section 1 above, the Service agrees as follows:

- (A) To treat each Contract that is still in force as of the effective date of this Agreement as having satisfied the requirements of § 7702 *[and § 7702A, if applicable]*, during the period from the date of issuance of the Contract through and including the later of (i) the date of the execution of this Agreement by the Service, or (ii) the date of any corrective action described in Section 1(D) above;
- (B) To treat each Contract that terminated prior to the effective date of this Agreement as having satisfied the requirements of § 7702 *[and § 7702A, if applicable]* during the period from date of issuance of the Contract through and including the date of the Contract's termination;
- (C) To treat the failures described above, and any corrective action described in Section 1(D) or 1(E) above, as having no effect on the date the Contract was issued or entered into;
- (D) To treat any amount paid prior to the effective date of this Agreement to any beneficiary under a Contract by reason of the death of the insured as paid under a life insurance contract for purposes of the exclusion from gross income under § 101(a)(1);
- (E) To waive civil penalties for failure of Taxpayer to satisfy the reporting, withholding, or deposit requirements for income deemed received by Contract holders under § 7702 *[and § 7702A, if applicable]*; and
- (F) To treat no portion of the amount described in Section 1(A) above as income to the Contract holders.

3. Any action required of Taxpayer in Section 1(D) or 1(E) above shall be taken by Taxpayer no later than ninety (90) days after the date of execution of this Agreement by the Service. Payment of the amount described in Section 1(A) above shall be made within thirty (30) days after the date of execution of this Agreement by the Service by check payable to the "United States Treasury" delivered together with a copy of this executed Agreement, to Internal Revenue Service, Receipt and Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

4. This Agreement is, and shall be construed as being, for the benefit of Taxpayer. Contract holders covered by this Agreement are intended beneficiaries of this Agreement. This Agreement shall not be construed as creating any liability of Taxpayer to the Contract holders.

5. Neither the Service nor Taxpayer shall endeavor by litigation or other means to attack the validity of this Agreement.

6. This Agreement may not be cited or relied upon as precedent in the disposition of any other matter.

NOW THIS CLOSING AGREEMENT FURTHER WITNESSETH, that the Service and Taxpayer mutually agree that the matters so determined shall be final and conclusive, except as follows:

- 1. The matter to which this Agreement relates may be reopened in the event of fraud, malfeasance, or misrepresentation of material facts set forth herein.
- 2. This Agreement is subject to sections of the Code that expressly provide that effect be given to their provisions notwithstanding any other law or rule of law except § 7122.
- 3. This Agreement is subject to any legislation enacted subsequent to the date of execution hereof if the legislation provides that it is effective with respect to closing agreements.

IN WITNESS WHEREOF, the parties have subscribed their names to these presents in triplicate.

*[Insert Taxpayer name]*

Date Signed: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

Date Signed: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

EXHIBIT C

Effective as of date executed by Internal  
Revenue Service \_\_\_\_\_

CLOSING AGREEMENT AS TO FINAL DETERMINATION  
COVERING SPECIFIC MATTERS  
UNDER SECTION 7702A

THIS CLOSING AGREEMENT (“Agreement”) is made pursuant to § 7121 of the Internal Revenue Code (the “Code”) by and between *[Insert Taxpayer name, address, and EIN]* (“Taxpayer”) and the Commissioner of Internal Revenue (the “Service”).

WHEREAS,

A. Taxpayer is the issuer of one or more life insurance contracts under § 7702;

B. Pursuant to Rev. Proc. 2001–42, 2001–2 C.B. 212, an issuer under certain circumstances may remedy an inadvertent non-regious failure to comply with the modified endowment contract rules under § 7702A.

C. By letter dated *[Insert date]*, Taxpayer submitted to the Service, pursuant to Rev. Proc. 2006–1, 2006–1 I.R.B. 1 *[or successor Rev. Proc., if applicable]*, a request for this Agreement covering *[Insert number]* modified endowment contracts identified on Exhibit A attached to this Agreement (the “Contracts”).

D. Taxpayer intended that each of the Contracts not be a modified endowment contract (MEC) under § 7702A. Taxpayer represents that the Contract[s] is [are] not described in Sec. 4.02 of Rev. Proc. 2001–42.

E. The Service has determined that the contracts identified on Exhibit A are eligible for relief under Rev. Proc. 2001–42.

F. Taxpayer represents that the cumulative “overage earnings,” within the meaning of Sec. 3.06 of Rev. Proc. 2001–42, for the Contract[s] equal \$ *[Insert amount]*.

G. Taxpayer represents that the total of the amounts determined under Sec. 5.03(1)(a), (b), and (c) of Rev. Proc. 2001–42, after taking the special rule in Sec. 5.03(2) of that revenue procedure into account, with regard to the Contract[s] are \$ *[Insert amount]*, \$ *[Insert amount]*, and \$ *[Insert amount]*, respectively.

H. To ensure that the Contract[s] is/are not treated as [a] modified endowment contract[s], Taxpayer and the Service have entered into this Agreement.

NOW THEREFORE, IT IS HEREBY FURTHER DETERMINED AND AGREED BETWEEN TAXPAYER AND THE SERVICE AS FOLLOWS:

1. In consideration for the agreement of the Service as set forth in Section 2 below, Taxpayer agrees as follows:

- (A) Taxpayer will pay to the Service the amount of \$ *[Insert amount]* at the time and in the manner described in Section 3 below.
- (B) The amount paid pursuant to Section 1(A) above is not deductible by Taxpayer, nor is such amount refundable, subject to credit or offset, or otherwise recoverable by Taxpayer from the Service.
- (C) For purposes of Taxpayer’s complying with its reporting and withholding obligations under the Code,
  - (i) neither the investment in the contract for purposes of § 72, nor the premiums paid for purposes of § 7702, on any Contract can be increased by any portion of the amount set forth in Section 1(A) above. If any such increases are made, they are entitled to no effect.



- (ii) neither the investment in the contract for purposes of § 72, nor the premiums paid, for purposes of § 7702, on any Contract can be increased by any portion of the amount which Taxpayer represents to be the income on the contract for all of the Contracts in the aggregate. If any such increases are made, they are entitled to no effect.
- (D) To bring Contract[s] for which the testing period (as defined in Sec. 3.01 of Revenue Procedure 2001-42) will not have expired on or before the date 90 days after the execution of this Agreement into compliance with § 7702A, either by an increase in death benefit[s] or the return of the excess premiums and earnings thereon to the contract holder[s].

2. In consideration of the agreement of Taxpayer set forth in Section 1 above, the Service agrees as follows:

- (A) To treat each Contract as having satisfied the requirements of § 7702A during the period from the date of issuance of the Contract through and including the later of—
  - (i) date of the execution of this Agreement, and
  - (ii) the date of the corrective actions described in Section 1(D) above;
- (B) To treat the corrective action described in 1(D) above as having no effect on the date the Contract was issued or entered into;
- (C) To waive civil penalties for failure of Taxpayer to satisfy the reporting, withholding, and/or deposit requirements for income subject to tax under § 72(e)(10) that was received or deemed received by a contract holder under a Contract in a calendar year ending prior to the date of execution of this Agreement; and
- (D) To treat no portion of the sum described in Section 1(A) above as income to the Contract holders.

3. The actions required of Taxpayer in Section 1(D) above shall be taken by Taxpayer no later than ninety (90) days after the date of execution of this Agreement by the Service. Payment of the amount described in Section 1(A) above shall be made within thirty (30) days of the date of execution of this Agreement by the Service by check payable to the “United States Treasury,” delivered together with a copy of this executed Agreement to Internal Revenue Service, Receipt & Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

4. This Agreement is, and shall be construed as being, for the benefit of Taxpayer. The Contract holders covered by this Agreement are intended beneficiaries of this Agreement. This Agreement shall not be construed as creating any liability of an issuer to the Contract holders.

5. Neither the Service nor Taxpayer shall endeavor by litigation or other means to attack the validity of this Agreement.

6. This Agreement may not be cited or relied upon as precedent in the disposition of any other matter.

NOW THIS CLOSING AGREEMENT FURTHER WITNESSETH, that Taxpayer and the Service mutually agree that the matters so determined shall be final and conclusive, except as follows:

1. The matter to which this Agreement relates may be reopened in the event of fraud, malfeasance, or misrepresentation of material facts set forth herein.

2. This Agreement is subject to sections of the Code that expressly provide that effect be given to their provisions notwithstanding any other law or rule of law except § 7122.

3. This Agreement is subject to any legislation enacted subsequent to the date of execution hereof if the legislation provides that it is effective with respect to closing agreements.

IN WITNESS WHEREOF, the parties have subscribed their names to these presents in triplicate.

*[Insert Taxpayer name]*

Date Signed: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

Date Signed: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

EXHIBIT D

Effective as of date executed by Internal  
Revenue Service \_\_\_\_\_

CLOSING AGREEMENT AS TO FINAL DETERMINATION  
COVERING SPECIFIC MATTERS  
UNDER SECTION 817(h)

THIS CLOSING AGREEMENT (“Agreement”), is made pursuant to § 7121 of the Internal Revenue Code (the “Code”) by and between *[Insert Taxpayer, Name, Address and EIN]* (Taxpayer”) and the Commissioner of Internal Revenue (the “Service”).

WHEREAS,

A. Taxpayer is the issuer of one or more variable contracts, as defined in § 817(d) (without regard to § 817(h)), which are based, in whole or in part, on a segregated asset account (the “Account”) and that provide for the allocation of amounts received under the variable contracts to the Account.

B. Pursuant to Rev. Proc. 92–25, 1992–1 C.B. 741, the Service may treat the investments of a segregated asset account on which a variable contract is based as satisfying the diversification requirements of § 817(h) and § 1.817–5(b) of the Income Tax Regulations for periods during which there was an inadvertent failure to diversify.

C. By letter dated *[Insert date,]* Taxpayer submitted to the Service, pursuant to Rev. Proc. 2006–1, 2006–1 I.R.B. 1 *[or successor Rev. Proc., if applicable]*, a request for this Agreement that the *[Insert account name]* be treated as adequately diversified under § 817(h) for the period *[Insert period of nondiversification]* (“the period of nondiversification”).

D. Taxpayer intended that Account be adequately diversified within the meaning of § 817 and § 1.817–5(b). The failure of the investments of the Account to satisfy the requirements of § 1.817–5(b) for the period of nondiversification was inadvertent.

E. The Service has determined that the failure of Account to satisfy the requirements of § 817(h) is eligible for relief under Rev. Proc. 92–25.

F. Taxpayer represents that the failure of the investments of the Account to satisfy the requirements of § 1.817–5(b) was discovered on *[Insert date]*, and the investments came into compliance with those requirements on *[Insert date]*.

G. The “income on the contract,” within the meaning of § 1.817–5(a)(2) and § 7702(g)(1)(B) (without regard to § 7701(g)(1)(C)), for all contracts based on the Account during the period of non-diversification in the aggregate totals \$*[Insert amount]* for the *[Insert account name]*.

H. The sum of the amounts computed in sections 4.02(1)(A) and (B) and 4.02(2)(A) of Rev. Proc. 92–25 is \$ *[Insert amount]*. The sum of the interest amounts computed in sections 4.02(1)(C) and 4.02(2)(A) of Rev. Proc. 92–25 is \$ *[Insert amount]*.

I. To ensure that variable contracts that provide for the allocation of amounts received thereunder to the Account are treated as annuity, endowment, or life insurance contracts, as applicable, Taxpayer and the Service have entered into this Agreement.

NOW THEREFORE, IT IS HEREBY FURTHER DETERMINED AND AGREED BETWEEN TAXPAYER AND THE SERVICE AS FOLLOWS:

1. In consideration for the agreement of the Service as set forth in Section 2 below, Taxpayer agrees as follows:
  - (A) Taxpayer will pay the Service the amount of \$ *[Insert amount]* at the time and in the manner described in Section 3 below.
  - (B) The amount paid pursuant to Section 1(A) above is not deductible, nor is such amount refundable, subject to credit or offset, or otherwise recoverable from the Service;
  - (C) For purposes of Taxpayer’s complying with its reporting and withholding obligations under the Code,

- (i) neither the investment in the contract for purposes of § 72, nor the premiums paid for purposes of § 7702 *[or § 101(f), if applicable]*, on any Contract can be increased by any portion of the amount set forth in Section 1(A) above. If any such increases are made, they are entitled to no effect.
- (ii) neither the investment in the contract for purposes of § 72, nor the premiums paid, for purposes of § 7702 *[or §101(f), if applicable]*, on any Contract can be increased by any portion of the amount which Taxpayer represents to be the income on the contract for all of the Contracts in the aggregate. If any such increases are made, they are entitled to no effect.

2. In consideration of the agreement of Taxpayer set forth in Section 1 above, the Service agrees as follows:

- (A) To treat the investments of the Account as adequately diversified for purposes of § 817(h) during the period of nondiversification; and
- (B) To treat no portion of the amounts described in Section 1(A) above as income to the Contract holders.

3. Payment of the sum described in section 1(A) above shall be made within thirty (30) days of the date of execution of this Agreement by the Service. This payment must be made by check payable to the "United States Treasury," delivered, together with a copy of this executed Agreement, to Internal Revenue Service Center, Receipt and Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

4. This Agreement is, and shall be construed as being, for the benefit of Taxpayer. Holders of contracts based on the Account are intended beneficiaries of this Agreement. This Agreement shall not be construed as creating any liability of Taxpayer to the holders of the contracts based on the Account.

5. Neither the Service nor Taxpayer shall endeavor by litigation or other means to attack the validity of this Agreement.

6. This Agreement may not be cited or relied upon as precedent in the disposition of any other matter.

NOW THIS CLOSING AGREEMENT FURTHER WITNESSETH, that the Service and Taxpayer mutually agree that the matters so determined shall be final and conclusive, except as follows:

- 1. The matter to which this Agreement relates may be reopened in the event of fraud, malfeasance, or misrepresentation of material facts set forth herein.
- 2. This Agreement is subject to sections of the Code that expressly provide that effect be given to their provisions notwithstanding any other law or rule of law except § 7122.
- 3. This Agreement is subject to any legislation enacted subsequent to the date of execution hereof if the legislation provides that it is effective with respect to closing agreements.

IN WITNESS WHEREOF, the parties have subscribed their names to these presents in triplicate.

*[Insert Taxpayer name]*

Date Signed: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

COMMISSIONER OF INTERNAL REVENUE

Date Signed: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

\_\_\_\_\_

## Rev. Proc. 2007-19

### SECTION 1. PURPOSE

This revenue procedure modifies the procedure by which an issuer of a life insurance contract may remedy an inadvertent non-egregious failure to comply with the modified endowment contract rules under § 7702A of the Internal Revenue Code. Rev. Proc. 2001-42, 2001-2 C.B. 212, is modified and amplified.

### SECTION 2. BACKGROUND

#### .01 Definition of a modified endowment contract

(1) Section 7702A(a) provides that a life insurance contract is a modified endowment contract (“MEC”) if the contract—

(a) is entered into on or after June 21, 1988, and fails to meet the “7-pay test” of § 7702A(b), or

(b) is received in exchange for a contract described in paragraph (a) of this section 2.01(1).

(2) A contract fails to meet the 7-pay test if the accumulated amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level premiums which would have to be paid on or before such time if the contract were to provide for paid-up “future benefits” (as defined in §§ 7702A(c)(3) and 7702(f)(4)) after the payment of 7 level annual premiums.

.02 Tax treatment of amounts received under a MEC. Section 72(e)(10) provides that a MEC is subject to the rules of § 72(e)(2)(B), which tax non-annuity distributions on an income-out-first basis, and the rules of § 72(e)(4)(A) (as modified by §§ 72(e)(10)(A)(ii) and 72(e)(10)(B)), which generally deem loans and assign-

ments or pledges of any portion of the value of a MEC to be non-annuity distributions. Moreover, under § 72(v), the portion of any annuity or non-annuity distribution received under a MEC that is includible in gross income is subject to a 10% additional tax unless the distribution is made on or after the date on which the taxpayer attains age 59½, is attributable to the taxpayer’s becoming disabled (within the meaning of § 72(m)(7)), or is part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and the taxpayer’s beneficiary.

.03 Rev. Proc. 2001-42. The Internal Revenue Service (“Service”) is aware of situations in which, as a result of inadvertent non-egregious failures to comply with the MEC rules, life insurance premiums are collected which exceed the 7-pay limit provided by § 7702A(b). This can produce significant unforeseen tax consequences for the contract holders. To allow issuers to remedy such situations, Rev. Proc. 2001-42 sets forth the circumstances under which the Service will enter into closing agreements which provide that contracts identified in the closing agreements will not be treated as MECs. Under Rev. Proc. 2001-42, an issuer must provide information about the contracts that are subject to the closing agreement, including a template for each contract setting forth the cumulative amounts paid under the contract, the contract’s cumulative 7-pay premium, the overage, if any, for each contract year, the earnings rate applicable for each contract year, and the overage earnings for each contract year. In addition, the issuer must agree to pay under the closing agreement an amount based on the contract’s overage, overage earnings, and tax and interest thereon.

.04 Need for changes to Rev. Proc. 2001-42. During the 5 years it has admin-

istered Rev. Proc. 2001-42, the Service has become aware of a number of changes that would make it easier for issuers to use that procedure to seek relief. The Service has determined that the General Account Total Return would be more accessible to taxpayers if based on Moody’s Seasoned Corporate Aaa and Baa Bond Yields, rather than on the indices provided in Rev. Proc. 2001-42; similarly, the Bond Fund Total Return would be more accessible if the Merrill Lynch Corporate Bond Master Bond Index, Total Return, were instead identified as the Merrill Lynch U.S. Corporate Master Index (C0A0); the Service has the capacity to process electronic exhibits in connection with requests for closing agreements involving life insurance contracts (see, e.g., Notice 2005-35, 2005-1 C.B. 1087); and, the Service has changed the address to which payments under Rev. Proc. 2001-42 must be sent.

### SECTION 3. CHANGES TO EXISTING PROCEDURE

.01 General Account Total Return. Rev. Proc. 2001-42, section 3.07(2), is modified to provide that the General Account Total Return is the arithmetic average (weighted on a 50-50 basis) of the following two rates: (1) Moody’s Seasoned Corporate Aaa Bond Yield, frequency annual; and (2) Moody’s Seasoned Corporate Baa Bond Yield, frequency annual. Both rates are published by Moody’s Investors Service, Inc., or any successor thereto, and are publicly available at [www.federalreserve.gov](http://www.federalreserve.gov). Under this methodology, the General Account Total Return for 2005 would be  $(5.23 + 6.06)/2 = 5.645$ . Section 3.07(2) is further modified to include the following tables setting forth the General Account Total Return as so determined for the years 1988 through 2005:

Year	General Account Total Return	Year	General Account Total Return
1988	10.2%	1997	7.6%
1989	9.7%	1998	6.9%
1990	9.8%	1999	7.4%
1991	9.2%	2000	8.0%
1992	8.6%	2001	7.5%
1993	7.5%	2002	7.2%
1994	8.3%	2003	6.2%
1995	7.8%	2004	6.1%
1996	7.7%	2005	5.6%

.02 *Variable Contracts Earnings Rate Table.* Rev. Proc. 2001-42, section 3.07(3), is modified by substituting the following earnings rate table for that which appears in section 3.07. This table supplements the existing table by providing earnings rates for the years 2001 through 2005:

Year	Variable contracts Earnings rate	Year	Variable contracts Earnings rate
1988	13.5%	1997	17.8%
1989	17.4%	1998	19.7%
1990	1.4%	1999	12.8%
1991	25.4%	2000	-5.5%
1992	5.9%	2001	-7.1%
1993	13.9%	2002	-14.1%
1994	-1.0%	2003	19.6%
1995	23.0%	2004	6.9%
1996	14.3%	2005	2.1%

.03 *Bond Fund Total Return.* Rev. Proc. 2001-42, section 3.07(6), is modified to provide that the Bond Fund Total Return is (a) the “calendar year percentage return” (as defined in section 3.07(7) of Rev. Proc. 2001-42) represented by the end-of-year values of the Merrill Lynch U.S. Corporate Master Index (C0A0), as published by Merrill Lynch & Company, Inc., or any successor thereto, less (b) 1.0 percentage point. The Merrill Lynch U.S. Corporate Master Index (C0A0) is publicly available at *www.mlindex.ml.com*. Under this methodology, the Bond Fund Total Return for 2005 would be  $((1546.511 - 1516.602) / 1516.602) - .01 = 0.9721$  percent.

.04 *Address for Payment.* The address set forth in Rev. Proc. 2001-42, section 5.04, for payment of the amount required under a closing agreement concerning inadvertent MECs is modified to read as follows: Internal Revenue Service, Receipt & Control Stop 31, 201 W. Rivercenter Blvd., Covington, KY 41011.

.05 *Electronic Submissions.* A new section 5.06 is added to Rev. Proc. 2001-42 to read as follows:

“.06 *Electronic submissions.* The information required under this revenue procedure may be submitted to the Service electronically, in read-only format, on a CD-ROM. Adobe Portable Document format is a suitable format. Other formats may be arranged on a case-by-case basis. The issuer must provide a total of 3 CD-ROMs, one for each of the three (3) copies of the closing agreement.”

.06 *Additional changes to Rev. Proc. 2001-42.* The Service is aware that additional changes to Rev. Proc. 2001-42 may be warranted. Notice 2007-15, page 503, this Bulletin, requests comments on a variety of issues affecting closing agreements for life insurance products, including inadvertent MECs. The Service will continue to process closing agreements under the provisions of Rev. Proc. 2001-42, as modified by this revenue procedure, until Rev. Proc. 2001-42 is replaced or further modified by publication in the Internal Revenue Bulletin.

#### SECTION 4. PAPERWORK REDUCTION ACT

The collections of information in Rev. Proc. 2001-42 have been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1752. This revenue procedure does not make substantive changes to those collections of information.

#### SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for submissions received after January 26, 2007, the date this revenue procedure was made available to the public.

#### SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2001-42 is modified and amplified.

## DRAFTING INFORMATION

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

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

*(Also: Part I, §§ 6011, 6111, 6112; 1.6011-4, 301.6112-1.)*

## Rev. Proc. 2007-20

### SECTION 1. PURPOSE

This revenue procedure provides that certain transactions with contractual protection are not reportable transactions for purposes of the disclosure rules under § 1.6011-4(b)(4) of the Income Tax Regulations. However, these transactions may be reportable transactions for purposes of the disclosure rules under § 1.6011-4(b)(2), (b)(3), (b)(5), (b)(6), or (b)(7).

### SECTION 2. BACKGROUND

.01 Section 1.6011-4 requires a taxpayer that participates in a reportable transaction to disclose the transaction in accordance with the procedures provided in § 1.6011-4. Under § 1.6011-4(b), one category of reportable transaction is a transaction with contractual protection. A transaction with contractual protection is defined in § 1.6011-4(b)(4). Generally, a transaction with contractual protection is a transaction involving a fee that is refundable if all or part of the intended tax consequences from the transaction are not sustained or a transaction involving a fee that is contingent on the taxpayer's realization of the tax benefits from the transaction.

.02 Section 1.6011-4(b)(8)(i) provides that a transaction will not be considered a

reportable transaction, or will be excluded from any individual category of reportable transaction, if the Commissioner makes a determination by published guidance that the transaction is not subject to the reporting requirements of § 1.6011-4.

### SECTION 3. SCOPE

This revenue procedure applies to taxpayers that may be required to disclose reportable transactions under § 6011, material advisors that may be required to disclose reportable transactions under § 6111, and material advisors that may be required to maintain lists under § 6112. This revenue procedure also applies for purposes of § 4965.

### SECTION 4. APPLICATION

.01 *In general.* The definition of a transaction with contractual protection includes references to "tax consequences" and "tax benefits." For purposes of § 1.6011-4, "tax" is defined as "Federal income tax." § 1.6011-4(c)(5). Accordingly, § 1.6011-4(b)(4) does not apply to transactions in which the refundable or contingent fees are based on the taxpayer's liability for taxes other than federal income taxes.

.02 *Exceptions.* The following transactions are not taken into account in determining whether a transaction is a transaction with contractual protection under § 1.6011-4(b)(4):

(1) Transactions in which the refundable or contingent fee is related to the work opportunity credit under § 51 of the Internal Revenue Code.

(2) Transactions in which the refundable or contingent fee is related to the welfare-to-work credit under § 51A.

(3) Transactions in which the refundable or contingent fee is related to the Indian employment credit under § 45A(a).

(4) Transactions in which the refundable or contingent fee is related to the low-income housing credit under § 42(a).

(5) Transactions in which the refundable or contingent fee is related to the new markets tax credit under § 45D(a).

(6) Transactions in which the refundable or contingent fee is related to the empowerment zone employment credit under § 1396(a).

(7) Transactions in which the refundable or contingent fee is related to the renewal community employment credit under § 1400H.

(8) Transactions in which the refundable or contingent fee is related to the employee retention credit under § 1400R(a), (b), or (c).

### SECTION 5. EFFECT ON OTHER DOCUMENTS

This document modifies and supersedes Rev. Proc. 2004-65, 2004-2 C.B. 965.

### SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 26, 2007, the date this revenue procedure was released to the public. The exceptions under section 4.02(1) through (3) apply to transactions that are entered into on or after January 1, 2003. The exceptions under section 4.02(4) through (8) apply to all transactions, regardless of when the transaction was entered into, that otherwise would have to have been disclosed under § 1.6011-4(b)(4) on or after January 1, 2006.

### SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Charles Wien of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue procedure, contact Mr. Wien at (202) 622-3070 (not a toll-free call).

## Part IV. Items of General Interest

### Income and Currency Gain or Loss With Respect to a Section 987 QBU; Correction

#### Announcement 2007-4

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking.

SUMMARY: This document contains corrections to a notice of proposed rulemaking (REG-208270-86, 2006-42 I.R.B. 698) that was published in the **Federal Register** on Thursday, September 7, 2006 (71 FR 52876), regarding the determination of the items of income or loss of a taxpayer with respect to a section 987 qualified business unit as well as the timing, amount character and source of any section 987 gain or loss.

FOR FURTHER INFORMATION CONTACT: Sheila Ramaswamy, (202) 622-3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Background

The notice of proposed rulemaking (REG-208270-86) that is the subject of these corrections is under section 987 of the Internal Revenue Code.

#### Need for Correction

As published, the notice of proposed rulemaking (REG-208270-86) contains errors that may prove to be misleading and are in need of clarification.

#### Correction of Publication

Accordingly, the notice of proposed rulemaking (REG-208270-86), that was the subject of FR Doc. 06-7250, is corrected as follows:

1. On page 52879, second column, in the preamble under the paragraph heading “E. Concerns Regarding the 1991 Proposed Regulations: Notice 2000-20,” the sixteenth line following the formula, the

language “DE. The DE conducts mineral” is corrected to read “DE. The DE conducts mineral extraction in Country X”.

2. On page 52886, first column, in the preamble under the paragraph heading “C. Section 1.987-3 Determination of the Items of Section 987 Taxable Income or Loss of an Owner of a Section 987 QBU,” the eighth line, the language “under other provisions are not taken” is corrected to read “under other provisions of the Code or regulations are not taken”.

3. On page 52886, second column, under the paragraph heading “C. Section 1.987-3 Determination of the Items of Section 987 Taxable Income or Loss of an Owner of a Section 987 QBU,” first full paragraph, ninth line from the bottom of the paragraph, the language “rates for amount realized and adjusted” is corrected to read “rates for the amount realized and adjusted”.

4. On page 52886, second column, under the paragraph heading “C. Section 1.987-3 Determination of the Items of Section 987 Taxable Income or Loss of an Owner of a Section 987 QBU,” second full paragraph, fifth line, the language “Generally the amount realized and” is corrected to read “Generally, the amount realized and adjusted”.

#### § 1.987-1 [Corrected]

5. On page 52895, second column, § 1.987-1(b)(7), paragraph (ii)(B) of *Example 1*, fifth line from the bottom of the paragraph, the language “neither the activities of DE1 or DE2 are” is corrected to read “the activities of DE1 are not”.

#### § 1.987-2 [Corrected]

6. On page 52899, first column, § 1.987-2(c)(9), lines 2 and 3, the language “illustrate the principles of this paragraph (c). For purposes of these” is corrected to read “illustrate the principles of paragraph (b) of this section and this paragraph (c). For purposes of these”.

7. On page 52899, second column, § 1.987-2(c)(9), paragraph (ii)(B) of *Example 1*, last line, the language “section 988 to X as a result of the loan.” is corrected to read “section 988 to X as a result of the disregarded loan.”

8. On page 52899, third column, § 1.987-2(c)(9), paragraph (ii)(A) of *Example 3*, line 3, the language “Federal tax purposes and therefore is a” is corrected to read “Federal income tax purposes and therefore is a”.

9. On page 52900, first column, § 1.987-2(c)(9), paragraph (ii)(C) of *Example 4*, line 3, the language “regarded for U.S. Federal tax purposes. As a” is corrected to read “regarded for U.S. Federal income tax purposes. As a”.

10. On page 52900, second column, § 1.987-2(c)(9), paragraph (ii)(A) of *Example 7*, line 1, the language “(ii) Analysis. (A) For Federal tax purposes” is corrected to read “(ii) Analysis. (A) For Federal income tax purposes”.

11. On page 52901, third column, § 1.987-2(d)(2), line 3, the language “described in section 988(c)(1)(i) and (ii)” is corrected to read “described in section 988(c)(1)(B)(i) and (ii)”.

#### § 1.987-3 [Corrected]

12. On page 52902, third column, § 1.987-3(e)(2), line 5, the language “described in section 988(c)(1)(A)(i) and” is corrected to read “described in section 988(c)(1)(B)(i) and”.

13. On page 52904, first column, § 1.987-3(f) *Example 3.*, the fourth line from the bottom of the paragraph, the language “section and § 1.987-1(c)(3) €8,000 x \$1=” is corrected to read “section and § 1.987-1(c)(3) (€8,000 x \$1=”.

#### § 1.987-6 [Corrected]

14. On page 52911, first column, § 1.987-6(c) *Example*, lines 5 through 10 from the bottom of the column, the language “of this section, Sf7,500 (Sf750,000/Sf1,000,000 x Sf10,000) of the section 987 gain will be treated as foreign source general limitation income which is not subpart F income and Sf2,500 (Sf250,000/Sf1,000,000 x Sf10,000) will” is corrected to read “of this section, Sf7,500 ((Sf750,000/Sf1,000,000) x Sf10,000) of the section 987 gain will be treated as foreign source general limitation income which is not subpart F income and Sf2,500 ((Sf250,000/Sf1,000,000) x Sf10,000) will”.

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

(Filed by the Office of the Federal Register on December 26, 2006, 8:45 a.m., and published in the issue of the Federal Register for December 27, 2006, 71 F.R. 77654)

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

### **Announcement 2007-13**

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 February 12, 2007, 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.

Hawaii Credit Counseling Service  
Honolulu, HI  
Lighthouse Credit Foundation, Inc.  
Largo, FL

## **Foundations Status of Certain Organizations**

### **Announcement 2007-14**

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

*Former Public Charities.* The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

3TO, Sunnyvale, CA  
According to His Riches Corporation,  
Washington, DC  
ActiVote America, Inc., Carmel, IN  
Africa Tent Evangelism, Inc.,  
Lubbock, TX  
African Aids Prevention and Medical Assistance Foundation, Charlotte, NC  
All Faith Youth Outreach Program, Inc.,  
Montgomery, AL  
Alliance Preparatory High School,  
Rancho Cucamonga, CA  
AMOR, Inc., Queens, NY  
Animal Resource Center, Inc., Slinger, WI  
Answer Evangelistic Ministries, Inc.,  
San Antonio, TX  
Arch Angel Arts Center, Rochelle, VA  
Aventis Behring Foundation for Research and Advancement of Patient Health,  
King of Prussia, PA  
Bamboo Village Hawaii, Inc.,  
Kurtistown, HI

Begin Again Ministries, Inc.,  
Springfield, MO  
Bethel Ministries, Inc., Huachuca City, AZ  
Better Days Ahead, Inc., Houston, TX  
B.F. Walker & Associates, Inc.,  
Atlanta, GA  
BHPS PTO, Inc., Tallahassee, FL  
Blessed Through You, Inc., Odenton, MD  
Breaking the Cycle, Inc., Smyrna, GA  
Bucklin Community Better Life Foundation, Bucklin, KS  
Building Doorways, Andover, MN  
Bullock Foundation, Inc., Charlotte, NC  
Butte Ski Club, Butte, MT  
Called to Serve, Troy, MI  
Cardiology P.C. Research Foundation,  
Birmingham, AL  
Casa Del Sol Mobile Home Corporation,  
Davis, CA  
CECN Foundation, Nacogdoches, TX  
Center for Civil War Living History, Inc.,  
Roanoke, VA  
Center for Regional Economic Strategies,  
Dayton, OH  
Central Washington Community Wellness Foundation, Ellensburg, WA  
Changed Lives Seminars and Ministry,  
Memphis, TN  
Chillicothe 757 Colts Baseball,  
Chillicothe, OH  
Christian Life School Foundation,  
Kenosha, WI  
Christian Rationalism Redeemer Center Correspondent, Inc., Waterbury, CT  
Clarence & Lynn Wolfe Foundation,  
Searcy, AR  
Columbus Georgia Wheelchair Athletic Association, Columbus, GA  
Community Finance Corporation,  
Tucson, AZ  
Community Healing Arts Center, Inc.,  
Florence, MA  
Community Health Resource, Inc.,  
Hogansville, GA  
Community Transportation Agency, Inc.,  
Wilmington, DE  
Conrad Charitable Foundation,  
Northville, MI  
Consciousness, Inc., Milwaukee, WI  
Coptic Legal Foundation, Glendale, CA  
Council for Educational Improvement,  
Santa Fe, NM  
Cri-Du-Chat Research Foundation,  
Cumming, GA  
Danielle Dawn Smalley Foundation, Inc.,  
Crandall, TX  
Danish American Language Foundation,  
St. Charles, IL



Danita Corbitt Memorial Scholarship, Inc., Rossville, GA  
 Developmental Education & Research, Inc., Chandler, AZ  
 Diamonds in the Rough, New Orleans, LA  
 Disabled First, Oceanside, CA  
 Disabled Traveler, Lapeer, MI  
 Do2Learn Foundation, Inc., Raleigh, NC  
 Doctor William H. Huger Home Charitable Trust, Charleston, SC  
 Dragon Fly After School Program, Cambridge, MA  
 Duxbury Recreation Foundation, Inc., Duxbury, MA  
 Eagle Feather Publishing and Research Institute, Austin, TX  
 El Leon Literary Arts, Inc., Berkeley, CA  
 Enchantment House Community Services, Incorporated, Missouri City, TX  
 Energy Farm, Jackson, MS  
 Energy for the Future, Rancho Cordova, CA  
 Engineers Rod & Gun Club Charities, Ottawa, IL  
 Eucalyptus View, Inc., Escondido, CA  
 Faithful Servant Ministries, Alvord, TX  
 Family Images, Inc., New York, NY  
 Family Unity World Wide, Rockmart, GA  
 First Baptist Faith Foundation, Hilton Head, SC  
 For the Love of Homeless Pets, Inc., Hiialeah Gardens, FL  
 Foundation for Consumers Construction Assistance, Inc., Bethany, OK  
 Foundation for in Home Care, Incorporated, Chattanooga, TN  
 Foundation for Integrative Therapies, Washington, DC  
 Foundation for Professional Excellence in the Community College, Austin, TX  
 Foundation for the Re-Entry of Ex-Offenders, Inc., (Free), Clinton, OH  
 Freedom Watch, Inc., Miami, FL  
 Gente Ayudando Gente S A, Houston, TX  
 Georgia Advocate Health Partners, Inc., Atlanta, GA  
 Grace Baptist Chapel Community Development Corporation, Bronx, NY  
 Grace Community Development Corporation, Memphis, TN  
 Grapevine Center for Communication Arts, Inc., Bloomfield, CT  
 Hair Angels Foundation, Inc., Carmel, IN  
 Healing the Environment, Inc., Thayne, WI  
 Hearts of Peace Foundation, Boulder, CO  
 Hope Foundation, Incorporated, Gaithersburg, MD  
 Housing & Community Synergy, Inc., Anaheim, CA  
 Howard Family Foundation, Inc., Los Angeles, CA  
 Human Services Projects, Inc., Park Forest, IL  
 Idaho Clean Air Foundation, Inc., Sandpoint, ID  
 Imani Support Services, Inc., Birmingham, AL  
 In His Rest Ministries, Anacortes, WA  
 Inner City Youth Computer Network, Philadelphia, PA  
 Inspirational Family Enrichment Association, Inc., Inkster, MI  
 Institute for the Advancement of Contemporary Chinese Architecture, Ltd., Oyster Bay, NY  
 Institute of Media Research, Inc., Cambridge, MA  
 Institute United for the Study and Defense Against Racism Toward Chinese People, Inc., Flushing, NY  
 Interdisciplinary Artists Aggregation, Inc., Santa Cruz, CA  
 International Justice Center, Inc., Suwanee, GA  
 International Latino Womens Congress, Philadelphia, PA  
 Isbell Home, Inc., Gadsden, AL  
 Jack and Elizabeth Gellman Torah Foundation, Inc., Amherst, NY  
 Jewishlinks, Inc., San Mateo, CA  
 Jo Saltkill Ministries, Inc., Ft. Worth, TX  
 John J. Barcklow Foundation, Inc., Springfield, VA  
 Cathedral Community Development, Inc., Tampa, FL  
 Kinderhudson Corporation, Nyack, NY  
 Ladwin Corp., San German, PR  
 Lafontaine Christian Church Scholarship Fund, Omaha, NE  
 Land Conservancy, Inc., Fairfield, NJ  
 Lark Second Chance, Harvey, IL  
 Laws of Life Expression Contest, Inc., Greensboro, NC  
 L D P Memorial Fund, Inc., Elizabeth, NJ  
 Linda Parham Ministries, Inc., Worcester, MA  
 Long March Foundation, Inc., New York, NY  
 Love for Life Foundation of Philippine American Physicians in America, Ledyard, CT  
 Lyceum Corporation, Dallas, TX  
 Making a Difference Foundation, Los Angeles, CA  
 Mapua Alumni Foundation, Inc., Yorba Linda, CA  
 Maridon Museum, Butler, PA  
 Marion Regional Healthcare Foundation, Mullins, SC  
 Mauldin Scholarship Charitable Trust, North Little Rock, AR  
 Metropolitan Community Housing and Development Organization, Inc., Baton Rouge, LA  
 Mirandette Martial Arts Center, Inc., Kentwood, MI  
 Moscow Directors' Art Theatre Studio of New York, New York, NY  
 Mount Pleasant Outreach Ministries, Inc., Atlanta, GA  
 Movement is Life, Inc., Detroit, MI  
 Moving Transit Through LA, Los Angeles, CA  
 NBCAR Historic District, Dothan, AL  
 Neurotherapy Research Association, Inc., Chevy Chase, MD  
 New Beginning Home Preparing for the Future, Winston Salem, NC  
 New Dimension Theatre Studio, Inc., Edgewater, NJ  
 New Vision Generational Learning Center, Kalamazoo, MI  
 Nickel of Hope, Cedar Hill, TX  
 Nile Vintage Group, Inc., Brooklyn, NY  
 Non Profit Secretarial Service NPSS, Inc., Houston, TX  
 North Coast Alliance, Cambria, CA  
 North Florida Housing, Inc., Newberry, FL  
 Note Worthy Outreach, Inc., Mission, KS  
 Notoriety, Inc., Irvine, CA  
 N.P.R.S.C., Inc., New Port Richey, FL  
 Nutritional Biomedicine Research Institute, Inc., Aspen, CO  
 Officeplease Foundation, Glen Ellen, CA  
 On Target of North Carolina, Inc., Kernersville, NC  
 Osseo Community Foundation, Osseo, MN  
 Our Father's House, Inc., Goose Creek, SC  
 Oxford Muse, Pearland, TX  
 Particle Economics Research Institute, Eastsound, WA  
 Partnership for Health, Healing & Community, Saco, ME  
 Perpetual Help Unlimited, Chicago, IL  
 Pineland Farms, Inc., New Gloucester, ME  
 Place of Hope Dog Rescue Foundation, Valentine, AZ  
 Pokagon Fund, Inc., New Buffalo, MI  
 Preventive Care for Productive Lives, Inc., Potomac, MD

Professionals Network of Florida, Inc.,  
 Jupiter, FL  
 Project Jakana, Ukiah, CA  
 Radar, Inc., Reno, NV  
 Rational Living Foundation, Inc.,  
 Tampa, FL  
 Real Estate Education Foundation,  
 Albuquerque, NM  
 Rhonda Joy Edwards Vansant Foundation,  
 Inc., Portland, OR  
 Rock Springs Community Center,  
 Mullin, TX  
 Rockville Striders Youth Track Club, Inc.,  
 Rockville, MD  
 Rozie Wilson White Agency, Inc.,  
 Cedar Hill, TX  
 Ruthmere Foundation, Inc., Elkhart, IN  
 Sea Life Studies, Inc., Morro Bay, CA  
 Seeds of Hope, Corralitos, CA  
 Senior Citizens Foundation, Inc.,  
 Deming, NM  
 Serv Behavioral Health Systems, Inc.,  
 West Trenton, NJ  
 Share the Warmth, Inc., Evansville, IN  
 Sharing the Journey, Toledo, OH  
 Sharon Sockwell-Clark Mission  
 Foundation, Inc., Bergheim, TX  
 Shield of Faith Out Reach Ministries, Inc.,  
 Atlanta, GA  
 Shirley A. Cunningham Jr. Family  
 Foundation, Inc., Georgetown, KY  
 Show Low Housing Coalition, Inc.,  
 Show Low, AZ  
 Sibley House, Nuevo, CA  
 Silence the Violence, Inc., Brooklyn, NY  
 Snow Cloud Farm, Inc., Asheville, NC  
 Solutions Community Outreach, Inc.,  
 Houston, TX  
 South Central Urban Ministries, Inc.,  
 Nashville, TN  
 Southwest Psychoanalytic Foundation,  
 Tucson, AZ  
 Spirit Investigations, Inc., Nashville, TN  
 Spotlight Fashion Group, Spartanburg, SC  
 SRDS, Sartell, MN  
 SS&W Enterprise, Inc., Philadelphia, PA  
 St. Augustine Foundation, Ltd.,  
 Yonkers, NY  
 St. Claude Community Family Center,  
 River Ridge, LA  
 Stewart W. and Willma C. Hoyt  
 Foundation, Binghamton, NY

Stratford Festival Theater, Inc.,  
 Fairfield, CT  
 Sundance Farm, Inc., Inman, KS  
 Supporting Parents Educational Dreams,  
 Inc., Portland, OR  
 Tallship Michigan, Franklin, MI  
 Talons & Tails, Inc., Bunnell, FL  
 Tarlow Family Foundation, Inc.,  
 St. Louis, MO  
 Temple Broadcasting Communication,  
 Inc., Simpsonville, SC  
 Texas Panhandle Film Commission,  
 Amarillo, TX  
 Thomasville Initiative, Thomasville, NC  
 Titusville Friends of the Arts,  
 Hydetsown, PA  
 To God be the Glory Ministries,  
 St. Louis, MO  
 Tony J. Ferry Ministries, Rehoboth, MA  
 Trail Corps Academy, Silverthorne, CO  
 United Charities of America,  
 San Angelo, TX  
 Upward Bound Youth Foundation, Inc.,  
 Clearwater, FL  
 Veneto Org, Washington, DC  
 Virtuous Women Under Construction,  
 Los Angeles, CA  
 VNA Foundation, Inc., Syracuse, NY  
 Walk-Ons, Inc., Salt Lake City, UT  
 Well Ministries, Inc., Wings Mills, MD  
 West Piedmont Workforce Investment  
 Board, Martinsville, VA  
 Wishing Well Foundation of America,  
 Inc., Palmetto Bay, FL  
 Women and Wisdom Foundation, Inc.,  
 Greensboro, NC  
 Women of Faith Ministries and Gods  
 Associates, Indianapolis, IN  
 Women of Light Foundation, Inc.,  
 Potomac, MD  
 Workers Housing Corporation,  
 San Juan, PR  
 WOW Community Outreach, Inc.,  
 Birmingham, AL  
 W.W.O.C.B. — “We Want Our Children  
 Back” Community Organization of  
 Athens, Athens, AL  
 Kristos Association, Inc.,  
 South Holland, IL  
 Yonkers Partnership Housing  
 Development Fund Corporation,  
 Yonkers, NY

Youth Determined to Succeed Y.D.T.S.,  
 Inc., Pittsburgh, PA  
 Youth Excelling Socially, Inc.,  
 Little Rock, AR  
 Youth of Promise, Irvine, CA

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)-7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

## Treatment of Payments in Lieu of Taxes Under Section 141

### Announcement 2007-19

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Cancellation of notice of public hearing on proposed rulemaking.

SUMMARY: This document cancels a public hearing on proposed regulations (REG-136806-06, 2006-47 I.R.B. 950) modifying the standards for treating payments in lieu of taxes (PILOTs) as generally applicable taxes for purposes of the private security or payment test under section 141.

DATES: The public hearing, originally scheduled for February 13, 2007 at 10 a.m. is cancelled.

FOR FURTHER INFORMATION CONTACT: Kelly Banks of the Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration) at (202) 622-0392 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**  
A notice of proposed rulemaking and notice of public hearing that appeared in the **Federal Register** on Thursday, October 19, 2006 (71 FR 61693), announced that a public hearing was scheduled for February 13, 2007, at 10 a.m. in the IRS Auditorium, New Carrollton Federal Building, 5000 Ellin Road, Lanham, MD 20706. Subsequently, a notice of change of location of public hearing was published in the **Federal Register** on Tuesday, December 26, 2006, (published as Announcement 2007-6, 2007-4 I.R.B. 376 [71 FR 77352]) changing the location to the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. The subject of the public hearing is under section 141 of the Internal Revenue Code.

The public comment period for these regulations expired on January 16, 2007.

The notice of proposed rulemaking and notice of public hearing instructed those interested in testifying at the public hearing to submit a request to speak and an outline of the topics to be addressed. As of Tuesday, January 23, 2007, no one has requested to speak. Therefore, the public hearing scheduled for February 13, 2007, is cancelled.

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

(Filed by the Office of the Federal Register on January 29, 2007, 8:45 a.m., and published in the issue of the Federal Register for January 30, 2007, 72 F.R. 4220)

# 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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