

## **HIGHLIGHTS OF THIS ISSUE**

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

### **INCOME TAX**

#### **Rev. Rul. 2006-49, page 584.**

**Interest rates; underpayments and overpayments.** The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 2006, will be 8 percent for overpayments (7 percent in the case of a corporation), 8 percent for underpayments, and 10 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 will be 5.5 percent.

#### **T.D. 9284, page 582.**

Final regulations under section 6502 of the Code incorporate changes imposed by the IRS Restructuring and Reform Act of 1988 that limit the IRS's ability to enter into agreements extending the statute of limitations for collection.

#### **REG-121509-00, page 602.**

Proposed regulations under sections 959, 961, and 1502 of the Code provide guidance relating to the exclusion from gross income of previously taxed earnings and profits under section 959 and related basis adjustments under section 961.

#### **REG-148576-05, page 627.**

Proposed regulations under 31 USC 9701 increase the amount of the user fees imposed under regulations sections 300.1 and 300.2 for entering into and restructuring or reinstating installment agreements. The regulations bring the fees in line with the actual costs to the IRS. Currently, the IRS charges \$43 for entering into an installment agreement and \$24 for restructuring or reinstating an installment agreement that is in default. The IRS recently completed a review of the installment agreement program and determined that the full cost of an installment agreement is \$105, and the full cost of restructuring or

reinstating an installment agreement is \$45. The regulations reflect these costs, with one exception; the fee for entering into an installment agreement paid by way of a direct debit from the taxpayer's checking account will be \$52, to encourage this type of payment arrangement. A public hearing is scheduled for October 17, 2006.

#### **Notice 2006-77, page 590.**

This notice republishes Notice 2006-67, 2006-33 I.R.B. 248, to reflect the citations to the final regulations for the additional first year depreciation deduction provided by section 168(k) of the Code. The notice provides guidance with respect to the 50-percent additional first year depreciation deduction provided by section 1400N(d) of the Code for qualified Gulf Opportunity (GO) Zone property. Notice 2006-67 modified and superseded. Rev. Proc. 2002-9 modified and amplified.

#### **Notice 2006-81, page 595.**

**Section 355.** This notice provides guidance for making an election under section 355(b)(3)(C) of the Code.

#### **Notice 2006-83, page 596.**

This notice provides guidance to individual chapter 11 debtors and their bankruptcy estates regarding the tax treatment of post-petition income as the result of the enactment of section 1115 of the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The notice also alerts information return preparers regarding their reporting responsibilities.

**(Continued on the next page)**

Finding Lists begin on page ii.



**Rev. Proc. 2006–39, page 600.**

This procedure provides the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under section 842(b) of the Code for taxable years beginning after December 31, 2004.

**Announcement 2006–71, page 630.**

This document cancels a public hearing on proposed regulations (REG–118775–06, 2006–28 I.R.B. 73) under sections 871 and 881 of the Code relating to the exclusion from gross income of portfolio interest paid to a nonresident alien individual or foreign corporation.

**Announcement 2006–72, page 630.**

This document contains a correction to final regulations (T.D. 9277, 2006–33 I.R.B. 226) providing guidance regarding employer comparable contributions to Health Savings Accounts (HSAs) under section 4980G of the Code.

## **EMPLOYEE PLANS**

**Notice 2006–80, page 594.**

**Weighted average interest rate update; corporate bond indices; 30-year Treasury securities.** The weighted average interest rate for September 2006 and the resulting permissible range of interest rates used to calculate current liability and to determine the required contribution are set forth.

**Announcement 2006–70, page 629.**

**Minimum funding standards; alternative funding schedule election.** This announcement describes how to make an election of an alternative funding schedule pursuant to section 402(a)(1) of the Pension Protection Act of 2006 (PPA) and contains background for that election.

## **EMPLOYMENT TAX**

**Notice 2006–83, page 596.**

This notice provides guidance to individual chapter 11 debtors and their bankruptcy estates regarding the tax treatment of post-petition income as the result of the enactment of section 1115 of the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The notice also alerts information return preparers regarding their reporting responsibilities.

## **SELF-EMPLOYMENT TAX**

**Notice 2006–83, page 596.**

This notice provides guidance to individual chapter 11 debtors and their bankruptcy estates regarding the tax treatment of post-petition income as the result of the enactment of section 1115 of the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The notice also alerts information return preparers regarding their reporting responsibilities.

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

## Introduction

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

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

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

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

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

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

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

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

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

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

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

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

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

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

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

## Section 6502.—Collection After Assessment

26 CFR 301.6501-1: Collection after assessment.

T.D. 9284

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 301

#### Collection After Assessment

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the collection of tax liabilities after assessment. The regulations reflect changes to the law made by the Internal Revenue Service Restructuring and Reform Act of 1998. These regulations affect persons determining how long the Internal Revenue Service has to collect taxes that have been properly assessed.

DATES: *Effective Date:* These regulations are effective September 6, 2006.

FOR FURTHER INFORMATION CONTACT: Debra A. Kohn, (202) 622-7985 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Background

This document contains amendments to the Procedure and Administration Regulations (26 CFR part 301) under section 6502 of the Internal Revenue Code (Code). The regulations reflect the amendment of the Code by section 3461 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998), Public Law 105-206 (112 Stat. 685, 764).

On March 4, 2005, a notice of proposed rulemaking (REG-148701-03, 2005-1 C.B. 802) relating to collection after assessment was published in the

Federal Register (70 FR 10572). No public hearing was requested or held. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed in this preamble.

#### Collection of Tax Liabilities after Assessment under Section 6502

Pursuant to section 6502 of the Code, the IRS generally has 10 years from the date of assessment to collect a timely assessed tax liability. Prior to January 1, 2000, the effective date of section 3461 of RRA 1998, section 6502 permitted the IRS to enter into agreements with the taxpayer to extend the period of limitations on collection at any time prior to the expiration of the period provided in section 6502. Prior to the enactment of RRA 1998, the IRS used these collection extension agreements, or waivers, in various circumstances to protect its ability to collect a tax liability beyond the original 10-year period of limitations on collection. For example, the IRS historically conditioned consideration of an offer in compromise upon the execution of a collection extension agreement or waiver.

In addition, the Code contains several provisions that operate to toll the period of limitations on collection upon the occurrence of certain events. For example, section 6331(k) operates in part to suspend the period of limitations on collection for the period of time during which an offer in compromise is pending, for 30 days after rejection, and while a timely filed appeal is pending. Similarly, section 6503(h) operates to suspend the period of limitations on collection for the period of time during which the IRS is prohibited from collecting a tax due to a bankruptcy proceeding, and for 6 months thereafter. These statutory suspension provisions toll the period of limitations on collection even if the period of limitations on collection previously has been extended pursuant to an executed collection extension agreement.

See *Klingshirn v. United States (In re Klingshirn)*, 147 F.3d 526 (6<sup>th</sup> Cir. 1998).

Section 3461 of RRA 1998 amended section 6502 of the Code to limit the ability of the IRS to enter into agreements extending the period of limitations on collection. Section 3461 of RRA 1998 also included an off-Code provision governing the continued effect of collection extension agreements executed on or before December 31, 1999.

#### Summary of Comments and Explanation of Provisions

The final regulations incorporate the amendments made by section 3461 of RRA 1998. The regulations provide that the IRS may enter into an agreement to extend the period of limitations on collection if an extension agreement is executed: (1) at the time an installment agreement is entered into; or (2) prior to release of a levy pursuant to section 6343, if the release occurs after the expiration of the original period of limitations on collection.

One set of comments received in response to the notice of proposed rulemaking recommended that the final regulations: 1) deem void all waivers signed prior to January 1, 2000, in conjunction with installment agreements that did not provide for payment in full of the underlying tax liability by the extended collection statute expiration date; and 2) provide that all taxpayers who have made payments since December 31, 2002, on such installment agreements are entitled to a refund of such payments. Because such provisions are beyond the scope of the underlying statute, they are not included in the final regulations.

Another set of comments received in response to the notice of proposed rulemaking concerned an inconsistency between the language of section 3461(c)(2) and a proposed alternative date of expiration for extension agreements made on or before December 31, 1999.

The notice of proposed rulemaking provided that extension agreements executed on or before December 31, 1999, other than those executed in connection with installment agreements, expire on the later

of: (1) December 31, 2002, or if earlier, the date on which the extension agreement expired by its terms; or (2) the end of the original 10-year statutory period. The comments reflect that the language of the proposed regulations is inconsistent with the language of the statute. Few cases exist in which waivers executed on or before December 31, 1999, are still open under the statutory framework. Thus, there is no longer a need to address this provision in final regulations.

To the extent that the notice of proposed rulemaking differs from the final regulations, it is withdrawn as of the effective date of the final regulations.

### Special Analyses

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

### Drafting Information

The principal author of these regulations is Debra A. Kohn of the Office of the Associate Chief Counsel (Procedure and Administration), Collection, Bankruptcy & Summonses Division.

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### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

#### PART 301—PROCEDURE AND ADMINISTRATION

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

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

Par. 2. Section 301.6502-1 is revised to read as follows:

#### *§301.6502-1 Collection after assessment.*

(a) *General rule.* In any case in which a tax has been assessed within the applicable statutory period of limitations on assessment, a proceeding in court to collect the tax may be commenced, or a levy to collect the tax may be made, within 10 years after the date of assessment.

(b) *Agreement to extend the period of limitations on collection.* The Secretary may enter into an agreement with a taxpayer to extend the period of limitations on collection in the following circumstances:

(1) *Extension agreement entered into in connection with an installment agreement.* If the Secretary and the taxpayer enter into an installment agreement for the tax liability prior to the expiration of the period of limitations on collection, the Secretary and the taxpayer, at the time the installment agreement is entered into, may enter into a written agreement to extend the period of limitations on collection to a date certain. A written extension agreement entered into under this paragraph shall extend the period of limitations on collection until the 89<sup>th</sup> day after the date agreed upon in the written agreement.

(2) *Extension agreement entered into in connection with the release of a levy under section 6343.* If the Secretary has levied on any part of the taxpayer's property prior to the expiration of the period of limitations on collection and the levy is subsequently released pursuant to section 6343 after the expiration of the period of limitations on collection, the Secretary and the taxpayer, prior to the release of the levy, may enter into a written agreement to extend the period of limitations on collection to a date certain. A written extension agreement entered into under this paragraph shall extend the period of limitations on collection until the date agreed upon in the extension agreement.

(c) *Proceeding in court for the collection of the tax.* If a proceeding in court for the collection of a tax is begun within the period provided in paragraph (a) of this section (or within any extended period as provided in paragraph (b) of this section), the period during which the tax may be collected by levy is extended until the liability

for the tax or a judgment against the taxpayer arising from the liability is satisfied or becomes unenforceable.

(d) *Effect of statutory suspensions of the period of limitations on collection if executed collection extension agreement is in effect.* (1) Any statutory suspension of the period of limitations on collection tolls the running of the period of limitations on collection, as extended pursuant to an executed extension agreement under paragraph (b) of this section, for the amount of time set forth in the relevant statute.

(2) The following example illustrates the principle set forth in this paragraph (d):

*Example.* In June of 2003, the Internal Revenue Service (IRS) enters into an installment agreement with the taxpayer to provide for periodic payments of the taxpayer's timely assessed tax liabilities. At the time the installment agreement is entered into, the taxpayer and the IRS execute a written agreement to extend the period of limitations on collection. The extension agreement executed in connection with the installment agreement operates to extend the period of limitations on collection to the date agreed upon in the extension agreement, plus 89 days. Subsequently, and prior to the expiration of the extended period of limitations on collection, the taxpayer files a bankruptcy petition under chapter 7 of the Bankruptcy Code and receives a discharge from bankruptcy a few months later. Assuming the tax is not discharged in the bankruptcy, section 6503(h) of the Internal Revenue Code operates to suspend the running of the previously extended period of limitations on collection for the period of time the IRS is prohibited from collecting due to the bankruptcy proceeding, and for 6 months thereafter. The new expiration date for the IRS to collect the tax is the date agreed upon in the previously executed extension agreement, plus 89 days, plus the period during which the IRS is prohibited from collecting due to the bankruptcy proceeding, plus 6 months.

(e) *Date when levy is considered made.* The date on which a levy on property or rights to property is considered made is the date on which the notice of seizure required under section 6335(a) is given.

(f) *Effective date.* This section is applicable on September 6, 2006.

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

Approved August 22, 2006.

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

(Filed by the Office of the Federal Register on September 5, 2006, 8:45 a.m., and published in the issue of the Federal Register for September 6, 2006, 71 F.R. 52444)

## Section 6621.—Determination of Rate of Interest

26 CFR 301.6621-1: Interest rate.

**Interest rates; underpayments and overpayments.** The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 2006, will be 8 percent for overpayments (7 percent in the case of a corporation), 8 percent for underpayments, and 10 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 will be 5.5 percent.

### Rev. Rul. 2006-49

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

Section 6621(c) provides that for purposes of interest payable under section 6601 on any large corporate underpayment, the underpayment rate under section

6621(a)(2) is determined by substituting “5 percentage points” for “3 percentage points.” See section 6621(c) and section 301.6621-3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and section 301.6621-3 are generally effective for periods after December 31, 1990.

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

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

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

Notice 88-59, 1988-1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of July 2006 is 5 percent. Accordingly, an overpayment rate of 8 percent (7 percent in the case of a corporation) and an underpayment rate of 8 percent are established for the calendar quarter beginning October 1, 2006. The overpayment rate for the portion of a corporate overpayment exceeding \$10,000 for the calendar quarter beginning October 1, 2006, is 5.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning October 1, 2006, is 10 percent. These rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 5.5 percent, 7 percent, 8 percent, and 10 percent are published in Tables 16, 19, 21, and 25 of Rev. Proc. 95-17, 1995-1 C.B. 556, 570, 573, 575, and 579.

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

### DRAFTING INFORMATION

The principal author of this revenue ruling is Crystal Foster of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue ruling, contact Ms. Foster at (202) 622-7198 (not a toll-free call).

TABLE OF INTEREST RATES  
PERIODS BEFORE JUL. 1, 1975 — PERIODS ENDING DEC. 31, 1986  
OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	In 1995-1 C.B. DAILY RATE TABLE
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581

TABLE OF INTEREST RATES  
PERIODS BEFORE JUL. 1, 1975 — PERIODS ENDING DEC. 31, 1986  
OVERPAYMENTS AND UNDERPAYMENTS — Continued

PERIOD	RATE	In 1995-1 C.B. DAILY RATE TABLE
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25, pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

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

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



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

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1998—Mar. 31, 1998	8%	21	575	9%	23	577
Apr. 1, 1998—Jun. 30, 1998	7%	19	573	8%	21	575
Jul. 1, 1998—Sep. 30, 1998	7%	19	573	8%	21	575
Oct. 1, 1998—Dec. 31, 1998	7%	19	573	8%	21	575

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

	RATE	1995-1 C.B.	
		TABLE	PG
Jan. 1, 1999—Mar. 31, 1999	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	6%	17	571
Jul. 1, 2005—Sep. 30, 2005	6%	17	571
Oct. 1, 2005—Dec. 31, 2005	7%	19	573
Jan. 1, 2006—Mar. 31, 2006	7%	19	573
Apr. 1, 2006—Jun. 30, 2006	7%	19	573
Jul. 1, 2006—Sep. 30, 2006	8%	21	575
Oct. 1, 2006—Dec. 31, 2006	8%	21	575

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

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1999—Mar. 31, 1999	6%	17	571	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	7%	19	573	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	7%	19	573	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	7%	19	573	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	7%	67	621	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	8%	69	623	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	8%	69	623	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	8%	69	623	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	8%	21	575	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	7%	19	573	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	6%	17	571	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	6%	17	571	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	5%	15	569	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	5%	15	569	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	5%	15	569	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	5%	15	569	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	4%	13	567	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	4%	13	567	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	4%	13	567	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	3%	11	565	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	3%	59	613	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	4%	61	615	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	3%	59	613	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	4%	61	615	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	4%	13	567	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	5%	15	569	6%	17	571
Jul. 1, 2005—Sep. 30, 2005	5%	15	569	6%	17	571
Oct. 1, 2005—Dec. 31, 2005	6%	17	571	7%	19	573
Jan. 1, 2006—Mar. 31, 2006	6%	17	571	7%	19	573
Apr. 1, 2006—Jun. 30, 2006	6%	17	571	7%	19	573
Jul. 1, 2006—Sep. 30, 2006	7%	19	573	8%	21	575
Oct. 1, 2006—Dec. 31, 2006	7%	19	573	8%	21	575

TABLE OF INTEREST RATES FOR  
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991 — PRESENT

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

TABLE OF INTEREST RATES FOR  
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991 — PRESENT — Continued

	RATE	1995-1 C.B. TABLE	PG
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581
Jan. 1, 1998—Mar. 31, 1998	11%	27	581
Apr. 1, 1998—Jun. 30, 1998	10%	25	579
Jul. 1, 1998—Sep. 30, 1998	10%	25	579
Oct. 1, 1998—Dec. 31, 1998	10%	25	579
Jan. 1, 1999—Mar. 31, 1999	9%	23	577
Apr. 1, 1999—Jun. 30, 1999	10%	25	579
Jul. 1, 1999—Sep. 30, 1999	10%	25	579
Oct. 1, 1999—Dec. 31, 1999	10%	25	579
Jan. 1, 2000—Mar. 31, 2000	10%	73	627
Apr. 1, 2000—Jun. 30, 2000	11%	75	629
Jul. 1, 2000—Sep. 30, 2000	11%	75	629
Oct. 1, 2000—Dec. 31, 2000	11%	75	629
Jan. 1, 2001—Mar. 31, 2001	11%	27	581
Apr. 1, 2001—Jun. 30, 2001	10%	25	579
Jul. 1, 2001—Sep. 30, 2001	9%	23	577
Oct. 1, 2001—Dec. 31, 2001	9%	23	577
Jan. 1, 2002—Mar. 31, 2002	8%	21	575
Apr. 1, 2002—Jun. 30, 2002	8%	21	575
Jul. 1, 2002—Sep. 30, 2002	8%	21	575
Oct. 1, 2002—Dec. 31, 2002	8%	21	575
Jan. 1, 2003—Mar. 31, 2003	7%	19	573
Apr. 1, 2003—Jun. 30, 2003	7%	19	573
Jul. 1, 2003—Sep. 30, 2003	7%	19	573
Oct. 1, 2003—Dec. 31, 2003	6%	17	571
Jan. 1, 2004—Mar. 31, 2004	6%	65	619
Apr. 1, 2004—Jun. 30, 2004	7%	67	621
Jul. 1, 2004—Sep. 30, 2004	6%	65	619
Oct. 1, 2004—Dec. 31, 2004	7%	67	621
Jan. 1, 2005—Mar. 31, 2005	7%	19	573
Apr. 1, 2005—Jun. 30, 2005	8%	21	575
Jul. 1, 2005—Sep. 30, 2005	8%	21	575
Oct. 1, 2005—Dec. 31, 2005	9%	23	577
Jan. 1, 2006—Mar. 31, 2006	9%	23	577
Apr. 1, 2006—Jun. 30, 2006	9%	23	577
Jul. 1, 2006—Sep. 30, 2006	10%	25	579
Oct. 1, 2006—Dec. 31, 2006	10%	25	579

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

	RATE	1995-1 C.B. TABLE	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572
Jan. 1, 1998—Mar. 31, 1998	6.5%	18	572
Apr. 1, 1998—Jun. 30, 1998	5.5%	16	570
Jul. 1, 1998—Sep. 30, 1998	5.5%	16	570
Oct. 1, 1998—Dec. 31, 1998	5.5%	16	570
Jan. 1, 1999—Mar. 31, 1999	4.5%	14	568
Apr. 1, 1999—Jun. 30, 1999	5.5%	16	570
Jul. 1, 1999—Sep. 30, 1999	5.5%	16	570
Oct. 1, 1999—Dec. 31, 1999	5.5%	16	570
Jan. 1, 2000—Mar. 31, 2000	5.5%	64	618
Apr. 1, 2000—Jun. 30, 2000	6.5%	66	620
Jul. 1, 2000—Sep. 30, 2000	6.5%	66	620
Oct. 1, 2000—Dec. 31, 2000	6.5%	66	620
Jan. 1, 2001—Mar. 31, 2001	6.5%	18	572
Apr. 1, 2001—Jun. 30, 2001	5.5%	16	570
Jul. 1, 2001—Sep. 30, 2001	4.5%	14	568
Oct. 1, 2001—Dec. 31, 2001	4.5%	14	568
Jan. 1, 2002—Mar. 31, 2002	3.5%	12	566
Apr. 1, 2002—Jun. 30, 2002	3.5%	12	566
Jul. 1, 2002—Sep. 30, 2002	3.5%	12	566
Oct. 1, 2002—Dec. 31, 2002	3.5%	12	566
Jan. 1, 2003—Mar. 31, 2003	2.5%	10	564
Apr. 1, 2003—Jun. 30, 2003	2.5%	10	564
Jul. 1, 2003—Sep. 30, 2003	2.5%	10	564
Oct. 1, 2003—Dec. 31, 2003	1.5%	8	562
Jan. 1, 2004—Mar. 31, 2004	1.5%	56	610
Apr. 1, 2004—Jun. 30, 2004	2.5%	58	612
Jul. 1, 2004—Sep. 30, 2004	1.5%	56	610
Oct. 1, 2004—Dec. 31, 2004	2.5%	58	612
Jan. 1, 2005—Mar. 31, 2005	2.5%	10	564
Apr. 1, 2005—Jun. 30, 2005	3.5%	12	566
Jul. 1, 2005—Sep. 30, 2005	3.5%	12	566
Oct. 1, 2005—Dec. 31, 2005	4.5%	14	568
Jan. 1, 2006—Mar. 31, 2006	4.5%	14	568
Apr. 1, 2006—Jun. 30, 2006	4.5%	14	568
Jul. 1, 2006—Sep. 30, 2006	5.5%	16	570
Oct. 1, 2006—Dec. 31, 2006	5.5%	16	570

# Part III. Administrative, Procedural, and Miscellaneous

## GO Zone Bonus Depreciation

### Notice 2006-77

#### SECTION 1. PURPOSE

This notice re-publishes Notice 2006-67, 2006-33 I.R.B. 248, to reflect the citations to the final regulations for the additional first year depreciation deduction provided by § 168(k) of the Internal Revenue Code that are published in the Federal Register on August 31, 2006 (71 FR 51727). Notice 2006-67 provided guidance with respect to the 50-percent additional first year depreciation deduction provided by § 1400N(d) (GO Zone additional first year depreciation deduction) for qualified Gulf Opportunity Zone property (GO Zone property). This notice provides that same guidance.

#### SECTION 2. BACKGROUND AND GO ZONE PROPERTY

.01 Section 1400N(d), added by section 101 of the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, 119 Stat. 2577, generally allows a 50-percent additional first year depreciation deduction for GO Zone property. The GO Zone additional first year depreciation deduction is allowable in the taxable year in which the GO Zone property is placed in service by the taxpayer. The computation of the allowable GO Zone additional first year depreciation deduction and the otherwise allowable depreciation deduction for GO Zone property is made in accordance with rules similar to the rules for 50-percent bonus depreciation property in § 1.168(k)-1(d)(1)(i), (1)(iii), and (2) of the Income Tax Regulations.

.02 GO Zone property is depreciable property that meets all of the following requirements:

(1) Property that is described in § 168(k)(2)(A)(i) and § 1.168(k)-1(b)(2)(i), or property that is nonresidential real property (as defined in § 168(e)(2)(B)) or residential rental property (as defined in § 168(e)(2)(A)) and depreciated under § 168;

(2) Substantially all of the use of the property is in the Gulf Opportunity (GO) Zone (as defined in § 1400M(1)) and in

the active conduct of a trade or business by the taxpayer in the GO Zone (for further guidance, see section 3 of this notice);

(3) The original use of the property commences with the taxpayer in the GO Zone on or after August 28, 2005. For purposes of this section 2.02(3), rules similar to the original use rules in § 1.168(k)-1(b)(3) apply. In addition, used property will satisfy the original use requirement so long as the property has not been previously used within the GO Zone;

(4) The property is acquired by the taxpayer by purchase (as defined in § 179(d) and § 1.179-4(c)) on or after August 28, 2005, but only if no written binding contract for the acquisition of the property was in effect before August 28, 2005. For purposes of this section 2.02(4), the rules in § 1.168(k)-1(b)(4)(ii) (binding contract), rules similar to the rules in § 168(k)(2)(E)(i) and § 1.168(k)-1(b)(4)(iii) (self-constructed property), and rules similar to the rules in § 168(k)(2)(E)(iv) and § 1.168(k)-1(b)(4)(iv) (disqualified transactions) apply; and

(5) The property is placed in service by the taxpayer on or before December 31, 2007 (December 31, 2008, in the case of qualified nonresidential real property and residential rental property).

.03 Depreciable property is not eligible for the GO Zone additional first year depreciation deduction if:

(1) The property is described in § 168(k)(2)(D)(i) and § 1.168(k)-1(b)(2)(ii)(A)(2);

(2) The property is described in § 168(f);

(3) Any portion of the property is financed with the proceeds of any obligation the interest on which is tax-exempt under § 103;

(4) The property is a qualified revitalization building (as defined in § 1400I(b)) for which the taxpayer has made an election under § 1400I(a)(1) or (a)(2) in accordance with section 7 of Rev. Proc. 2003-38, 2003-1 C.B. 1017;

(5) The property is included in any class of property for which the taxpayer elects not to deduct the GO Zone additional first

year depreciation (for further guidance, see section 4 of this notice);

(6) The property is described in § 1400N(p)(3) (for further guidance, see section 5 of this notice);

(7) The property is placed in service and disposed of during the same taxable year. However, rules similar to the rules in § 1.168(k)-1(f)(1)(ii) and (iii) (technical termination of a partnership under § 708(b)(1)(B) or transactions described in § 168(i)(7)) apply; or

(8) The property is converted from business or income-producing use to personal use in the same taxable year in which the property is placed in service by a taxpayer.

.04 The counties and parishes in Alabama, Louisiana, and Mississippi that comprise the GO Zone are listed on page 2 of *IRS Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma*, under Gulf Opportunity (GO) Zone (Core Disaster Area).

.05 If depreciable property is not GO Zone property in the taxable year in which the property is placed in service by the taxpayer, the GO Zone additional first year depreciation deduction is not allowable for the property even if a change in use of the property subsequent to the placed-in-service year of the property results in the property being GO Zone property. See § 1.168(k)-1(f)(6)(iv)(B).

.06 Limitation provisions of the Code (for example, §§ 465, 469, and 704(d)) apply and may limit the amount of the GO Zone additional first year depreciation deduction that may be claimed by a taxpayer subject to such a provision.

#### SECTION 3. SUBSTANTIALLY ALL AND ACTIVE CONDUCT REQUIREMENTS UNDER § 1400N(d)(2)(A)(ii)

.01 *Substantially All Requirement.* Each depreciable property will meet the requirements of § 1400N(d)(2)(A)(ii) if substantially all of the use of the property is in the GO Zone and in the active conduct of a trade or business by the taxpayer in the GO Zone. For this purpose, the term "substantially all" means 80 percent or more during each taxable year. If greater than 20 percent of the use of the property either is outside the counties and parishes

designated as being part of the GO Zone or is not in the active conduct of a trade or business by the taxpayer in the GO Zone, then the property is not GO Zone property and is not eligible for the GO Zone additional first year depreciation deduction.

The following example illustrates the provisions of this section 3.01 and section 2.05 of this notice.

*Example.* A, a calendar-year taxpayer, owns and operates a furniture store in the GO Zone. In December 2006, A purchases a new delivery truck and places it in service for use in A's business. The delivery truck is used less than 80 percent in the GO Zone in 2006 and is used 80 percent or more in the GO Zone in 2007 and 2008. Because the delivery truck does not meet the substantially all requirement described in this section 3.01 in its placed-in-service year (2006), the truck is not GO Zone property. Thus, the truck does not qualify for the GO Zone additional first year depreciation deduction, regardless of the fact that substantially all of the use of the truck is in the GO Zone in 2007 and 2008.

#### .02 Active Conduct of a Trade or Business Requirement.

(1) *Trade or business definition.* For purposes of § 1400N(d)(2)(A)(ii), the term "trade or business" has the same meaning as in § 162 and the regulations thereunder. Thus, property held merely for the production of income or used in an activity not engaged in for profit (as described in § 183) does not qualify for the GO Zone additional first year depreciation deduction.

(2) *Active conduct.* Solely for purposes of § 1400N(d)(2)(A)(ii), the determination of whether a trade or business is actively conducted by the taxpayer is to be made based on all of the facts and circumstances. A taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business. Furthermore, for purposes of § 1400N(d)(2)(A)(ii), a partner, member, or shareholder of a partnership, limited liability company, or S corporation, respectively, is considered to actively conduct a trade or business of the partnership, limited liability company, or S corporation if the partnership, limited liability company, or S corporation meaningfully participates (through the activities performed by itself, or by others on behalf of the partnership, limited liability company, or S corporation, respectively) in the management or operations of the trade or business. Similar rules apply to other pass-thru entities such as trusts or estates.

(3) *Examples.* The following examples illustrate the provisions of section 3.02 of this notice.

(a) *Example 1.* During 2006, MNO, a limited liability company, constructs and places in service a new apartment building in the GO Zone. MNO is treated as a partnership for federal tax purposes. B, a member in MNO, manages and operates this apartment building for MNO. Because B manages and operates the apartment building for MNO, MNO meaningfully participates in the management and operations of the apartment building. Consequently, all of the use of the apartment building is in the GO Zone and in the active conduct of a trade or business by MNO in the GO Zone. Accordingly, the unadjusted depreciable basis (as defined in § 1.168(b)-1T(a)(3)) of the apartment building qualifies for the GO Zone additional first year depreciation deduction (assuming all other requirements are met). However, limitation provisions of the Code (for example, § 469) apply and may limit the amount of the GO Zone additional first year depreciation deduction that may be claimed by the members of MNO.

(b) *Example 2.* During 2006, C, an individual, places in service a new restaurant in the GO Zone and employs D to operate it. During 2006, C periodically met with D to review operations relating to the restaurant. C also approved the restaurant's budget for 2006 that was prepared by D. D performs all the necessary operating functions, including hiring chefs, acquiring the necessary food and restaurant supplies, and writing the checks to pay all bills and the chefs' salaries. Based on these facts and circumstances, C meaningfully participates in the management of the restaurant. Consequently, all of the use of the restaurant is in the GO Zone and in the active conduct of a trade or business by C in the GO Zone. Accordingly, the unadjusted depreciable basis of the restaurant qualifies for the GO Zone additional first year depreciation deduction (assuming all other requirements are met). However, limitation provisions of the Code (for example, § 469) apply and may limit the amount of the GO Zone additional first year depreciation deduction that may be claimed by C.

(c) *Example 3.* During 2006, PRS, a partnership, constructs and places in service a new small commercial building in the GO Zone and leases it to E, an unrelated party, who uses the building as a fast food restaurant. This building is the only property owned by PRS. The lease agreement between PRS and E is a triple net lease under which E is responsible for all of the costs relating to the building (for example, paying all taxes, insurance, and maintenance expenses) in addition to paying rent. Because of the triple net lease, PRS does not meaningfully participate in the management or operations of the building and the building is not used in the active conduct of a trade or business by PRS in the GO Zone. Accordingly, the building does not qualify for the GO Zone additional first year depreciation deduction.

(d) *Example 4.* Same facts as Example 3, except that PRS, during 2006, constructs and places in service two other new commercial buildings in the GO Zone and leases these buildings to F, an unrelated party, who uses the two other buildings as office space. The lease agreement between PRS and F is not a triple net lease. G, a partner in PRS, manages and operates the two office buildings for PRS. Because G manages and operates the two office buildings for

PRS, PRS meaningfully participates in the management and operations of the two office buildings. Consequently, these two office buildings are used in the active conduct of a trade or business by PRS in the GO Zone. Accordingly, the total unadjusted depreciable basis of the two office buildings leased to F qualifies for the GO Zone additional first year depreciation deduction (assuming all other requirements are met). However, limitation provisions of the Code (for example, § 469) apply and may limit the amount of the GO Zone additional first year depreciation deduction that may be claimed by the partners of PRS with respect to the two buildings leased to F. Further, because the requirements of § 1400N(d)(2)(A)(ii) apply on a property-by-property basis, the building leased to E does not qualify for the GO Zone additional first year depreciation deduction, as provided in Example 3.

## SECTION 4. ELECTION NOT TO DEDUCT GO ZONE ADDITIONAL FIRST YEAR DEPRECIATION

.01 *In General.* Pursuant to § 1400N(d)(2)(B)(iv), a taxpayer may make an election not to deduct the GO Zone additional first year depreciation for any class of property that is GO Zone property placed in service during the taxable year. If a taxpayer makes this election, then the election applies to all GO Zone property that is in the same class of property and placed in service in the same taxable year, and no additional first year depreciation deduction is allowable for the class of property. In addition, the depreciation adjustments under § 56 apply to that property for purposes of computing the taxpayer's alternative minimum taxable income. The election not to deduct the GO Zone additional first year depreciation is made by each person owning GO Zone property (for example, for each member of a consolidated group by the common parent of the group, by the partnership, or by the S corporation).

.02 *Definition of Class of Property.* For purposes of the election under § 1400N(d)(2)(B)(iv) not to deduct the GO Zone additional first year depreciation, the term "class of property" means:

(1) Except for the property described in this section 4.02(2), (3), (4), (5), and (6), each class of property described in § 168(e) (for example, 5-year property);

(2) Water utility property as defined in § 168(e)(5) and depreciated under § 168;

(3) Computer software as defined in, and depreciated under, § 167(f)(1) and the regulations thereunder;

(4) Qualified leasehold improvement property as defined in § 168(k)(3) and § 1.168(k)-1(c) and depreciated under § 168;

(5) Nonresidential real property as defined in § 168(e)(2)(B) and depreciated under § 168; or

(6) Residential rental property as defined in § 168(e)(2)(A) and depreciated under § 168.

#### *.03 Time and Manner of Making the Election.*

(1) *In general.* An election not to deduct the GO Zone additional first year depreciation for any class of property that is GO Zone property placed in service during the taxable year must be made by the due date (including extensions) of the federal income tax return for the taxable year in which the GO Zone property is placed in service by the taxpayer. The election must be made in the manner prescribed on Form 4562, *Depreciation and Amortization*, and its instructions.

If a taxpayer files its 2004 or 2005 federal income tax return on or after September 13, 2006, then the taxpayer must follow the instructions for the 2005 Form 4562 (Rev. January 2006) for the manner for making the election not to deduct the GO Zone additional first year depreciation for any class of property that is GO Zone property placed in service by the taxpayer on or after August 28, 2005, during the taxpayer's taxable year beginning in 2004 or 2005 (2004 or 2005 taxable year). If a taxpayer files its 2004 or 2005 federal income tax return before September 13, 2006, then see section 4.03(2) of this notice for the procedures for making the election not to deduct the GO Zone additional first year depreciation for any class of property that is GO Zone property placed in service by the taxpayer on or after August 28, 2005, during the taxpayer's 2004 or 2005 taxable year.

(2) *Special rules for 2004 or 2005 federal income tax return filed before September 13, 2006.*

(a) *In general.* If a taxpayer files its 2004 or 2005 federal income tax return before September 13, 2006, then the taxpayer has made the election not to deduct the GO Zone additional first year depreciation for a class of property that is GO Zone property placed in service by the taxpayer on or after August 28, 2005, during the tax-

payer's 2004 or 2005 taxable year, if the taxpayer:

(i) made the election within the time prescribed in section 4.03(1) of this notice and in the manner prescribed in the instructions for the 2005 Form 4562 (Rev. January 2006) (that is, attach a statement to the taxpayer's timely filed return (including extensions) indicating the class of property for which the taxpayer is making the election and that, for such class of property, the taxpayer is electing not to claim the GO Zone additional first year depreciation deduction); or

(ii) made the deemed election provided for in section 4.03(2)(b) of this notice.

(b) *Deemed election.* If section 4.03(2)(a)(i) of this notice does not apply, a taxpayer that files its 2004 or 2005 federal income tax return before September 13, 2006, will be treated as having made the election not to deduct the GO Zone additional first year depreciation for a class of property that is GO Zone property placed in service by the taxpayer on or after August 28, 2005, during the taxpayer's 2004 or 2005 taxable year, if the taxpayer:

(i) on that return, did not claim the GO Zone additional first year depreciation deduction for that class of property but did claim depreciation; and

(ii) does not file an amended federal tax return for the taxpayer's 2004 or 2005 taxable year on or before February 14, 2007, or a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's federal tax return for the taxpayer's next succeeding taxable year, to claim the GO Zone additional first year depreciation deduction for that class of property.

If a Form 3115 is filed under section 4.03(2)(b)(ii) of this notice, the Form 3115 must be filed in accordance with the automatic change in method of accounting provisions of Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, or any successor. The change in method of accounting from filing the Form 3115 results in a § 481(a) adjustment. Further, the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply. Moreover, for purposes of section 6.02(4)(a) of Rev. Proc.

2002-9, the taxpayer should include on line 1a of the Form 3115 the designated automatic accounting method change number "104".

Section 1.446-1(e)(3)(ii) authorizes the Commissioner of Internal Revenue to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting. In addition, section 2.04 of Rev. Proc. 2002-9 provides that unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in method of accounting, regardless of whether the change is from a permissible or an impermissible method. *See generally* Rev. Rul. 90-38, 1990-1 C.B. 57.

.04 *Revocation.* An election not to deduct the GO Zone additional first year depreciation for a class of property that is GO Zone property is revocable only with the prior written consent of the Commissioner. To seek the Commissioner's consent, the taxpayer must submit a request for a letter ruling in accordance with the provisions of Rev. Proc. 2006-1, 2006-1 I.R.B. 1 (or any successor).

.05 *Failure to Make Election Not to Deduct GO Zone Additional First Year Depreciation.* If a taxpayer does not make the election described in section 4.01 of this notice within the time and in the manner prescribed in section 4.03 of this notice, the amount of depreciation allowable for that property under § 167(f)(1) or under § 168, as applicable, must be determined for the placed-in-service year and for all subsequent taxable years by taking into account the GO Zone additional first year depreciation deduction. Thus, the election not to deduct the GO Zone additional first year depreciation cannot be made by the taxpayer in any other manner (for example, through a request under § 446(e) to change the taxpayer's method of accounting).

## SECTION 5. CERTAIN PROPERTY NOT ELIGIBLE FOR THE GO ZONE ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION

.01 *In General.* Section 1400N(p)(1) disallows the GO Zone additional first year depreciation deduction for any property described in § 1400N(p)(3). Pursuant to § 1400N(p)(3)(A), such property includes:

(1) any property used in connection with any private or commercial golf course, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises (“prohibited activities”); or

(2) any gambling or animal racing property.

*.02 Prohibited Activities.*

(1) *Real property used for both a prohibited activity and a non-prohibited activity.* Solely for purposes of § 1400N(d), the portion of any real property (determined by square footage) that is dedicated to any prohibited activity described in section 5.01(1) of this notice is not eligible for the GO Zone additional first year depreciation deduction. If real property is used for both a prohibited activity and an activity not described in section 5.01(1) of this notice, the portion of the real property (determined by square footage) that is not dedicated to the prohibited activity is eligible for the GO Zone additional first year depreciation deduction (assuming all other requirements under § 1400N(d) are met). For example, the GO Zone additional first year depreciation deduction for a shopping center that has both a suntan salon and businesses not described in section 5.01(1) of this notice (and that otherwise qualifies for the GO Zone additional first year depreciation deduction under § 1400N(d)), is determined without regard to the portion of the shopping center’s unadjusted depreciable basis that bears the same percentage to the total unadjusted depreciable basis as the percentage of square footage dedicated to the prohibited activity (that is, the suntan salon) bears to the total square footage of the shopping center.

(2) *Trade or business activity that derives a small percentage of gross receipts from certain prohibited activities.*

(a) *De minimis rule.* Solely for purposes of § 1400N(p)(3)(A)(i), a taxpayer’s trade or business activity that has less than 10 percent of its total gross receipts derived from massages, tanning services, or a hot tub facility is not treated as, respectively, a massage parlor, a suntan facility, or a hot tub facility. Such trade or business activity may include, for example, a physical therapy office or a beauty/day spa salon if its gross receipts derived from massages, suntanning, and hot tub facilities are less than 10 percent of its total gross receipts.

In determining whether this less than 10 percent test is satisfied, only gross receipts from the taxpayer’s trade or business activity that includes the massages, tanning services, or hot tub facility are taken into account. Further, if a taxpayer is a member of a consolidated group, only the gross receipts of the taxpayer (and not the consolidated group) are taken into account. Also, if the taxpayer is a partnership, S corporation, or other pass-thru entity, only the gross receipts of the pass-thru entity (and not the owners of the pass-thru entity) are taken into account.

(b) *Definition of gross receipts.* For purposes of this section 5.02(2), the term “gross receipts” means the taxpayer’s receipts for the taxable year that are recognized under the taxpayer’s methods of accounting used for federal income tax purposes for the taxable year. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of § 103), dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the taxpayer’s trade or business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in § 1221(a)(1), (3), (4), or (5). With respect to sales of capital assets as defined in § 1221, or sales of property described in § 1221(a)(2) (relating to property used in a trade or business), gross receipts are reduced by the taxpayer’s adjusted basis in such property. Gross receipts do not include the amounts received in repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts re-

ceived that are allocable to the payment of such tax.

*.03 Gambling or Animal Racing Property.*

(1) *In general.* Section 1400N(p)(3)(B)(i) defines the term “gambling or animal racing property” as meaning:

(a) any equipment, furniture, software, or other property used directly in connection with gambling, the racing of animals, or the on-site viewing of such racing; and

(b) the portion of any real property (determined by square footage) that is dedicated to gambling, the racing of animals, or the on-site viewing of such racing. However, pursuant to § 1400N(p)(3)(B)(ii), if the portion of the real property dedicated to gambling, the racing of animals, or the on-site viewing of such racing is less than 100 square feet, then that portion is not gambling or animal racing property. For example, no apportionment is required under this 100-square-foot *de minimis* rule in the case of a retail store that sells lottery tickets in a less than 100 square foot area.

(2) *Real property not dedicated to gambling or animal racing.* Real property that is not dedicated to gambling, the racing of animals, or the on-site viewing of such racing but is attached to such gaming facilities is eligible for the GO Zone additional first year depreciation deduction (assuming all other requirements under § 1400N(d) are met). Such property may include, for example, hotels, restaurants, and parking lots of gaming facilities. For example, the GO Zone additional first year depreciation deduction for a building that is used as both a casino and a hotel (and that otherwise qualifies for the GO Zone additional first year depreciation deduction under § 1400N(d)), is determined without regard to the portion of the building’s unadjusted depreciable basis that bears the same percentage to the total unadjusted depreciable basis as the percentage of square footage dedicated to gambling (that is, the casino floor) bears to the total square footage of the building.

**SECTION 6. RECAPTURE RULES UNDER § 1400N(d)(5)**

*.01 In General.* Section 1400N(d)(5) provides that for purposes of § 1400N(d), rules similar to the recapture rules under § 179(d)(10) and § 1.179-1(e) apply with respect to any GO Zone property that ceases to be GO Zone property.



.02 *Application*. If GO Zone property is no longer GO Zone property in the hands of the same taxpayer at any time before the end of the GO Zone property's recovery period as determined under § 167(f)(1) or § 168, as applicable, then the taxpayer must recapture in the taxable year in which the GO Zone property is no longer GO Zone property (the recapture year) the benefit derived from claiming the GO Zone additional first year depreciation deduction for such property. The benefit derived from claiming the GO Zone additional first year depreciation deduction for the property is equal to the excess of the total depreciation claimed (including the GO Zone additional first year depreciation deduction) for the property for the taxable years before the recapture year over the total depreciation that would have been allowable for the taxable years before the recapture year as a deduction under § 167(f)(1) or § 168, as applicable, had the GO Zone additional first year depreciation deduction not been claimed (regardless of whether such excess reduced the taxpayer's tax liability). The amount to be recaptured is treated as ordinary income for the recapture year. For the recapture year and subsequent taxable years, the taxpayer's deductions under § 167(f)(1) or § 168, as applicable, are determined as if no GO Zone additional first year depreciation deduction was claimed with respect to the property. If, subsequent to the recapture year, a change in the use of the property results in the property again being GO Zone property, then the GO Zone additional first year depreciation deduction is not allowable for the property.

.03 *Examples*. The following examples illustrate the provisions of this section 6.

(a) *Example 1*. *H*, a calendar-year taxpayer, owns and operates a furniture store in the GO Zone. In December 2006, *H* purchases a new delivery truck for \$50,000 and places it in service for use in *H*'s business. For 2006, this delivery truck is GO Zone property and is 5-year property under § 168(e). *H* depreciates its 5-year property placed in service in 2006 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. During 2007, the delivery truck is used less than 80 percent in the GO Zone.

(i) For 2006, *H* is allowed the GO Zone additional first year depreciation deduction of \$25,000 for the delivery truck (unadjusted depreciable basis of \$50,000 multiplied by .50). In addition, *H*'s depreciation deduction allowable in 2006 for the remaining

adjusted depreciable basis of \$25,000 for the delivery truck (the unadjusted depreciable basis of \$50,000 reduced by the GO Zone additional first year depreciation deduction of \$25,000) is \$5,000 (the remaining adjusted depreciable basis of \$25,000 multiplied by the annual depreciation rate of .20 for recovery year 1). Thus, *H*'s depreciation deduction allowable in 2006 for the delivery truck totals \$30,000.

(ii) For 2007, because the delivery truck does not meet the substantially all requirement described in section 3.01 of this notice, the delivery truck is no longer GO Zone property. Accordingly, for 2007, *H* must recapture as ordinary income \$20,000 (\$30,000 depreciation claimed by *H* for the truck before 2007 less the \$10,000 depreciation that would have been allowable for the truck before 2007 had the GO Zone additional first year depreciation deduction not been claimed (unadjusted depreciable basis of \$50,000 multiplied by the cumulative annual depreciation rate of .20 before 2007)). In addition, *H*'s depreciation deduction allowable in 2007 for the delivery truck is \$16,000 (unadjusted depreciable basis of \$50,000 multiplied by the annual depreciation rate of .32 for recovery year 2) (determined as if no GO Zone additional first year depreciation deduction was claimed for the truck).

(b) *Example 2*. Same facts as in *Example 1*, except that during 2008, the delivery truck is used 80 percent or more in the GO Zone. The GO Zone additional first year depreciation deduction is not allowable for the delivery truck even though the truck is GO Zone property in the hands of *H* in 2008. Thus, for 2008, *H*'s depreciation deduction allowable in 2008 for the delivery truck is \$9,600 (unadjusted depreciable basis of \$50,000 multiplied by the annual depreciation rate of .1920 for recovery year 3) (determined as if no GO Zone additional first year depreciation deduction was claimed for the truck).

## SECTION 7. EFFECT ON OTHER DOCUMENTS

.01 Notice 2006-67, 2006-33 I.R.B. 248, is modified and superseded.

.02 Rev. Proc. 2002-9 is modified and amplified to include the automatic change in method of accounting provided under section 4.03(2)(b) of this notice in section 2 of the APPENDIX of Rev. Proc. 2002-9.

## SECTION 8. DRAFTING INFORMATION

The principal author of this notice is Douglas H. Kim of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Mr. Kim at (202) 622-3110 (not a toll-free call).

## Weighted Average Interest Rate Update

### Notice 2006-80

This notice provides guidance as to the corporate bond weighted average interest rate and the permissible range of interest rates specified under § 412(b)(5)(B)(ii)(II) of the Internal Revenue Code. In addition, it provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II).

### CORPORATE BOND WEIGHTED AVERAGE INTEREST RATE

Sections 412(b)(5)(B)(ii) and 412(l)(7)(C)(i), as amended by the Pension Funding Equity Act of 2004 and by the Pension Protection Act of 2006, provide that the interest rates used to calculate current liability and to determine the required contribution under § 412(l) for plan years beginning in 2004 through 2007 must be within a permissible range based on the weighted average of the rates of interest on amounts invested conservatively in long term investment grade corporate bonds during the 4-year period ending on the last day before the beginning of the plan year.

Notice 2004-34, 2004-1 C.B. 848, provides guidelines for determining the corporate bond weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability. That notice establishes that the corporate bond weighted average is based on the monthly composite corporate bond rate derived from designated corporate bond indices. The methodology for determining the monthly composite corporate bond rate as set forth in Notice 2004-34 continues to apply in determining that rate. See Notice 2006-75, 2006-36 I.R.B. 366.

The composite corporate bond rate for August 2006 is 6.11 percent. Pursuant to Notice 2004-34, the Service has determined this rate as the average of the monthly yields for the included corporate bond indices for that month.

The following corporate bond weighted average interest rate was determined for plan years beginning in the month shown below.

Month	For Plan Years Beginning in:	Year	Corporate Bond Weighted Average	90% to 100% Permissible Range
September		2006	5.78	5.21 to 5.78

### 30-YEAR TREASURY SECURITIES INTEREST RATE

Section 417(e)(3)(A)(ii)(II) defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)-1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury securities for August 2006 is 5.00 percent. The Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2036.

#### Drafting Information

The principal authors of this notice are Paul Stern and Tony Montanaro of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Stern may be reached at 202-283-9703. Mr. Montanaro may be reached at 202-283-9714. The telephone numbers in the preceding sentences are not toll-free.

### Elections Under § 355(b)(3)(C)

#### Notice 2006-81

This notice provides guidance for making an election under § 355(b)(3)(C) of the Internal Revenue Code.

#### BACKGROUND

Section 355(b)(3) was enacted on May 17, 2006, as part of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 348. Section 355(b)(1) generally provides, in part, that § 355(a) only applies to transactions in which both the distributing corporation and the controlled corporation are engaged in the active conduct of a trade or business immediately after the distribution. Section 355(b)(2) generally provides, in part, that, for purposes of § 355(b)(1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if such corporation is engaged in the active conduct of a trade or business, or if substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) that is so engaged (the latter phrase hereinafter referred to as the "Holding Company Test").

New § 355(b)(3)(A) generally provides that, for distributions made after May 17, 2006, and on or before December 31, 2010, a corporation shall be treated as meeting the requirements of § 355(b)(2)(A) if and only if such corporation is engaged in the active conduct of a trade or business. New § 355(b)(3)(B) generally provides that, for purposes of § 355(b)(3)(A), all members of such corporation's separate affiliated group shall be treated as one corporation. Section 355(b)(3)(B) also provides that a corporation's separate affiliated group is the affiliated group that would be determined under § 1504(a) if such corporation were the common parent and § 1504(b) did not apply. Thus, in light of the restrictive language in § 355(b)(3), the Holding

Company Test does not apply to any distribution for which § 355(b)(3) applies.

New § 355(b)(3)(C) contains transition rules providing that § 355(b)(3)(A) shall not apply to any distribution made pursuant to a transaction that was: (i) made pursuant to an agreement that was binding on May 17, 2006, and at all times thereafter; (ii) described in a ruling request submitted to the Internal Revenue Service on or before May 17, 2006; or, (iii) described on or before May 17, 2006, in a public announcement or in a filing with the Securities and Exchange Commission. Therefore, corporations whose distributions are described in the preceding sentence and otherwise meet the requirements of § 355 shall be governed under § 355(b)(2)(A) (including the Holding Company Test), notwithstanding the enactment of § 355(b)(3). However, § 355(b)(3)(C) also provides that these corporations may elect not to have the transition rule apply. If one of these corporations elects not to have the transition rule apply, § 355(b)(3)(A) and (B) will apply. Any such election, once made, shall be irrevocable.

The Service has determined that corporations whose transactions are described in the transition rule and who desire tax-free treatment under § 355 will not be required to make an affirmative election under § 355(b)(3)(C), provided that their transaction is described in § 355(b) as in effect either before or after the enactment of § 355(b)(3). Such corporations will be deemed to have satisfied the requirements of § 355(b)(2)(A) or (b)(3), as applicable. However, corporations must make the election described in § 355(b)(3)(C) if the purpose of the election is to disqualify the distribution under § 355(a). Corporations whose transactions are described in the transition rule but do not desire tax-free treatment under § 355 and require § 355(b)(2)(A) to apply to ensure taxable treatment are not required to file the election, but must report the distribution as taxable.

The Service will treat elections as effective under § 355(b)(3)(C) if they are made in the form and manner as set forth in this notice. The Service will also treat elections as effective under § 355(b)(3)(C) if they are made in a different form and manner, provided that the form and manner of the election apprise the Service that an election has been made with respect to a particular transaction and by particular parties.

## PROCEDURES

If a distributing corporation makes a distribution of stock or securities of a controlled corporation in a transaction described in § 355(b)(3)(C)(i), (ii), or (iii), it intends that the distribution not qualify under § 355(a), and it is making the election described in § 355(b)(3)(C) to ensure that result, the distributing corporation may make a valid election by including a statement as described below on or with its tax return filed by the due date (including extensions) for filing its original return for the taxable year in which the distribution occurs.

The statement should be titled “ELECTION PURSUANT TO NOTICE 2006–81 BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY)], A DISTRIBUTING CORPORATION.” The statement should provide the names and taxpayer identification numbers, if any, of the distributing and controlled corporations and should include a representation that the distributing corporation is eligible to make the election described in this notice and that the distributing corporation elects to have § 355(b)(3) apply to its distribution.

## EFFECTIVE DATE

This notice is effective for all elections under § 355(b)(3)(C).

## DRAFTING INFORMATION

The principal author of this notice is Sameera Y. Hasan of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Sameera Y. Hasan at (202) 622–7770 (not a toll-free call).

## Individual Chapter 11 Debtors Notice 2006–83

This notice provides guidance for individuals who file bankruptcy cases under Chapter 11 of the Bankruptcy Code (11 U.S.C. § 1101 *et seq.*) on or after October 17, 2005. This notice also provides guidance for (1) employers of these individuals, (2) persons filing Forms W–2, 1099–INT, 1099–DIV, 1099–MISC, and other information returns (including Schedule K–1) that report payments to these individuals, and (3) Chapter 11 trustees in bankruptcy cases filed by these individuals. Upon consideration of the comments received concerning this notice, as requested in section 7, additional guidance may be published.

## Section 1. PURPOSE

The bankruptcy estate of a Chapter 11 debtor who is an individual is a separate taxable entity under section 1398 of the Internal Revenue Code. The estate, rather than the debtor, must include in its gross income all of the debtor’s income to which the estate is entitled under the Bankruptcy Code, except for amounts received or accrued by the debtor before the commencement of the case. Section 1115 of the Bankruptcy Code was enacted by section 321(a)(1) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), Pub. L. No. 109–8, 119 Stat. 23 (2005) and is effective for cases filed on or after October 17, 2005. As a result of the enactment of section 1115, the bankruptcy estate, rather than the debtor, must include in its gross income both (1) the debtor’s gross earnings from his or her performance of services after the commencement of the case (“post-petition services”) and (2) the gross income from property acquired by the debtor after the commencement of the case (“post-petition property”). I.R.C. § 1398(e)(1). The gross earnings from post-petition services include wages and other compensation earned by a debtor who is an employee and self-employment income earned by a debtor who is a self-employed individual.

## Section 2. BACKGROUND AND GENERAL LEGAL PRINCIPLES

.01 The commencement of a bankruptcy case creates an estate, which generally includes all legal or equitable interests of the debtor in property as of the commencement of the case. 11 U.S.C. § 541(a)(1). Specific exclusions apply, however. See 11 U.S.C. § 541(b) (excluded property). See also 11 U.S.C. § 522 (exempt property); 11 U.S.C. § 554 (abandoned property). Exempt property and abandoned property are initially part of the bankruptcy estate, but are subsequently removed from the estate. By contrast, property excluded from the estate is never included in the estate.

.02 Confirmation of a Chapter 11 plan of reorganization generally vests all the property of the estate in the debtor, except as otherwise provided in the plan or in the court order confirming the plan. 11 U.S.C. § 1141(b). If no plan is confirmed and a bankruptcy case is dismissed, the property of the estate generally reverts in the debtor, unless the court orders otherwise. 11 U.S.C. § 349(b)(3).

.03 When a trustee is appointed pursuant to section 1104 of the Bankruptcy Code, the debtor generally must turn over to the trustee control over the assets of the bankruptcy estate. In most Chapter 11 cases, a trustee is not appointed and the debtor (referred to as the debtor in possession) remains in control of the property of the bankruptcy estate. Under section 1107(a) of the Bankruptcy Code, the debtor in possession must perform all the functions and duties of a trustee, except for the duties specified in Bankruptcy Code section 1106(a)(2), (3) and (4).

.04 Because the bankruptcy estate is a separate taxable entity, the trustee or debtor in possession must obtain an employer identification number (EIN) for the estate. I.R.C. § 6109. The trustee or debtor in possession uses the EIN on any tax returns filed for the estate.

.05 Section 1398(e)(1) of the Code provides that the gross income of the estate includes the gross income of the debtor to which the estate is entitled under the Bankruptcy Code. Section 1398(e)(2) provides that the gross income of the debtor does not include any item to the extent the item is included in the gross income of the bankruptcy estate.

.06 In general, the determination of whether or not any amount paid or incurred by the estate is allowable as a deduction or credit to the estate shall be made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and businesses, and in the activities, the debtor was engaged in before the commencement of the case. I.R.C. § 1398(e)(3)(A). The estate is, however, specifically allowed a deduction for administrative expenses allowed under section 503 of the Bankruptcy Code and for any fee or charge assessed against the estate under chapter 123 of title 28 of the United States Code. I.R.C. § 1398(h)(1).

.07 The individual debtor must continue to file his or her own individual tax returns during the bankruptcy proceedings. I.R.C. § 6012(a)(1).

.08 For bankruptcy cases filed *before* October 17, 2005, the property of the estate does not generally include any post-petition property acquired by an individual Chapter 11 debtor. Nor in those cases does the property of the estate include the individual Chapter 11 debtor's earnings from post-petition services, because section 541(a)(6) of the Bankruptcy Code specifically excluded those earnings from the estate. *See, e.g., In re Fitzsimmons*, 725 F.2d 1208 (9<sup>th</sup> Cir. 1984); *In re Larson*, 147 B.R. 39 (Bankr. D.N.D. 1992). Therefore, in these cases income from post-petition property and earnings from post-petition services are not generally includible in the estate's gross income. Instead, such income and earnings are generally includible in the debtor's gross income.

.09 Section 321 of BAPCPA made several changes to Chapter 11, effective for bankruptcy cases filed by individuals *on or after* October 17, 2005. Although many of the provisions that apply to individual Chapter 11 cases now operate in a manner similar to the provisions that apply in Chapter 13 cases, section 1398 of the Internal Revenue Code has not been amended and continues to apply to individual Chapter 11 cases, but not to Chapter 13 cases. Based on section 1115 of the Bankruptcy Code, read in conjunction with section 1398(e)(1) of the Internal Revenue Code, the debtor's *gross* earnings from post-petition services and *gross* income from post-petition property are, in general, includible in the bankruptcy

estate's gross income, rather than in the debtor's gross income. This rule is subject to the exceptions noted below in sections 2.10, 2.11, 2.12, and 2.13.

.10 If a chapter 11 case is converted to a Chapter 13 case, the Chapter 13 estate is not a separate taxable entity and earnings from post-conversion services and income from property of the estate realized after the conversion to Chapter 13 are taxed to the debtor. I.R.C. § 1399.

.11 If the Chapter 11 case is converted to a Chapter 7 case, section 1115 will not apply after conversion and earnings from post-conversion services will be taxed to the debtor, rather than the estate. 11 U.S.C. § 541(a)(6). In such a case, the property of the Chapter 11 estate will become property of the Chapter 7 estate. Any income on this property will be taxed to the estate even if the income is realized after the conversion to Chapter 7.

.12 If a Chapter 11 case is dismissed, the debtor is treated as if the bankruptcy case had never been filed and as if no bankruptcy estate had been created. I.R.C. § 1398(b)(1).

.13 For Chapter 11 cases filed by individuals on or after October 17, 2005, the estate's gross income includes gross income from property held by the debtor when the case commenced ("pre-petition property"), as was the case under pre-BAPCPA law. There are certain exceptions to this general rule, however. The gross income on pre-petition property is included in the gross income of the debtor, rather than the estate, if the pre-petition property is excluded from the estate and the gross income is subject to taxation. Also, the gross income on pre-petition property is included in the gross income of the debtor, rather than the estate, *after* the pre-petition property is removed from the estate by exemption or abandonment.

### Section 3. FILING INCOME TAX RETURNS OF THE DEBTOR AND THE ESTATE; NOTIFICATION TO PERSONS FILING INFORMATION RETURNS (OTHER THAN FORM W-2) OF THE STATUS OF THE CHAPTER 11 BANKRUPTCY CASE

.01 The debtor in possession or trustee, if one is appointed, must prepare and file the income tax returns of the bankruptcy estate if required under section 6012(a)(9).

I.R.C. § 6012(b)(4). In preparing the income tax returns of the debtor and the bankruptcy estate, the debtor in possession (or the trustee) must follow the rules stated in sections 2.09, 2.10, 2.11, 2.12, and 2.13 of this notice, and must attach to the returns the statement discussed in section 6.

.02 A debtor in possession may be compensated by the estate to manage or operate a trade or business that the debtor conducted before the commencement of the bankruptcy case. Such payments should be reportable by the debtor as miscellaneous income on his or her individual income tax return. I.R.C. § 61(a). Amounts paid by the estate to the debtor in possession for managing or operating the trade or business may qualify as administrative expenses of the estate. An administrative expense allowed by the bankruptcy court under section 503 of the Bankruptcy Code will generally be deductible by the estate as an administrative expense when it is paid or incurred. I.R.C. § 1398(h)(1).

.03 Within a reasonable time after the commencement of a Chapter 11 bankruptcy case, the trustee (if one is appointed) or the debtor in possession should provide notification of the bankruptcy estate's EIN to persons that are required to file information returns with respect to the bankruptcy estate's gross income, gross proceeds, or other types of reportable payments. I.R.C. § 6109(a)(2). Since these payments are property of the estate under section 1115, such persons should report the gross income, gross proceeds, or other reportable payment on an appropriate information return using the estate's name and EIN in the time and manner required under the Internal Revenue Code and regulations (*see, e.g.,* sections 6041 through 6049). The trustee or debtor in possession should *not*, however, provide the EIN to the debtor's employer or other person filing Form W-2 with respect to the debtor's wages or other compensation, since section 1115 does not affect the determination of what constitutes wages for purposes of Federal income tax withholding or the Federal Insurance Contributions Act. I.R.C. §§ 3121(a) and 3401(a). As provided in section 5, an employer should continue to report all wage income and accompanying tax withholdings, whether pre-petition or post-petition, on a Form W-2 issued to the debtor under the debtor's social security number. See

sections 6721 through 6724 for applicable penalties for failure to comply with information reporting requirements, including providing taxpayer identification numbers, and provisions for penalty waivers for reasonable cause.

.04 When a Chapter 11 bankruptcy case is closed, dismissed, or converted to a case under Chapter 12 or 13 of the Bankruptcy Code, the bankruptcy estate ends as a separate taxable entity. The debtor should, within a reasonable time, provide notification of the closing, dismissal, or conversion to the persons that were previously notified of the bankruptcy case under section 3.03 to the extent notification is necessary to ensure that gross income, gross proceeds, and other types of reportable payments realized after the closing, dismissal, or conversion are reported to the proper person and with the correct taxpayer identification number. Gross income, gross proceeds, and other reportable payments realized after the closing, dismissal, or conversion to Chapter 12 or 13 should, in general, be reported to the debtor, rather than the estate.

.05 If the Chapter 11 case is converted to a Chapter 7 case, the bankruptcy estate will continue to exist as a separate taxable entity and gross income (other than post-conversion income from the debtor's services), gross proceeds, or other reportable payments should continue to be reported to the estate if the gross income, gross proceeds, or other reportable payment represents property of the Chapter 7 estate. As section 2.11 notes, income from services performed by the debtor after conversion to Chapter 7 is not property of the Chapter 7 bankruptcy estate. Therefore, within a reasonable time after the conversion to Chapter 7, the debtor should notify payors required to report the debtor's nonemployee compensation on Form 1099-MISC that such compensation earned after the conversion to Chapter 7 should be reported using the debtor's name and taxpayer identification number, rather than the estate's name and TIN.

.06 The debtor is not required to file a new Form W-4 with an employer adjusting the debtor's withholding allowances solely because the debtor has filed a Chapter 11 case and his or her post-petition wages are includible in the gross income of the estate. This is true even though the estate may be taxed at a higher tax

rate than the debtor and is entitled to only one personal exemption. A new Form W-4 may be necessary, however, under the applicable regulations when, for instance, the debtor employee is no longer entitled to claim the same number of allowances claimed on the Form W-4 previously provided to the employer, such as for certain deductions or credits that now belong to the estate. See § 31.3402(f)(2)-1 of the Employment Tax Regulations. Furthermore, even where not required, in some circumstances it may be prudent for the debtor to file a new Form W-4 to increase the amount of income tax withheld from the debtor's post-petition wages that will be allocated to the estate in accordance with section 6. Otherwise, estimated tax payments on behalf of the estate may be required in order to avoid a penalty for underpayment of estimated tax. See section 6654(a).

#### Section 4. APPLICATION OF THE SELF-EMPLOYMENT TAX

.01 Section 1401 of the Internal Revenue Code imposes a tax upon the self-employment income of every individual. The term "self-employment income" means the net earnings from self-employment derived by an individual. I.R.C. § 1402(b). The term "net earnings from self-employment" means, in relevant part, the gross income derived by an individual from any trade or business carried on by such individual less deductions allowed attributable to such trade or business. I.R.C. § 1402(a).

.02 Under section 1115 of the Bankruptcy Code, the earnings from a Chapter 11 debtor's post-petition services, including the debtor's self-employment income, constitute property of the estate under section 1115. As property of the estate, the income from post-petition services is includible in the income of the bankruptcy estate, rather than the income of the debtor. I.R.C. § 1398(e)(1). However, neither section 1115 of the Bankruptcy Code nor section 1398 of the Internal Revenue Code addresses the application of the self-employment tax to the earnings from the individual debtor's continuing services. Because the debtor continues to derive gross income from the performance of services as a self-employed individual after the commencement of the bankruptcy case, the debtor must continue to report on Schedule

SE of the debtor's individual income tax return the self-employment income earned post-petition, which includes the attributable deductions, and must pay the resulting self-employment tax imposed by section 1401.

#### Section 5. APPLICATION OF EMPLOYMENT TAXES AND OBLIGATION TO FILE FORM W-2

.01 As a result of the enactment of section 1115, post-petition wages earned by a debtor are generally treated for *income tax* purposes as gross income of the estate, rather than the debtor. The reporting and withholding obligations of a debtor's employer, however, have not changed as a result of the enactment of section 1115. Section 1115 has no effect on the determination of wages under the Federal Insurance Contributions Act (FICA), including application of the contribution and benefit base (as determined under section 230 of the Social Security Act). I.R.C. § 3121(a). Similarly, the enactment of section 1115 has no effect on the determination of wages for Federal Unemployment Tax Act (FUTA) tax or Federal Income Tax Withholding purposes. See I.R.C. §§ 3306(b) and 3401(a).

.02 Since section 1115 does not affect the application of FICA tax, FUTA tax, or Federal Income Tax Withholding, with respect to the wages of a Chapter 11 debtor in a case commenced on or after October 17, 2005, an employer should continue to reflect such wages and accompanying tax withholdings on a Form W-2 issued to the debtor under the debtor's name and social security number.

#### Section 6. ALLOCATION OF INCOME AND CREDITS ON INFORMATION RETURNS AND REQUIRED STATEMENT FOR RETURNS

.01 When an employer issues a Form W-2 to a Chapter 11 debtor reporting all of the debtor's wages, salary, or other compensation to the debtor for a calendar year, and a portion of the wages, salary, or other compensation represents earnings from post-petition services includible in the estate's gross income under section 1398(e)(1), an allocation of the amounts reported on the Form W-2 must be made. The debtor in possession, or the trustee,

if one is appointed, must allocate in a reasonable manner wages, salary, or other compensation reported in box 1 and the withheld income tax reported in box 2 of Form W-2 between the debtor and the estate. The allocations must be in accordance with all the rules stated in sections 2.09, 2.10, 2.11, 2.12, and 2.13 of this notice. If reasonable, the debtor and trustee may use a simple percentage method for allocating income and withheld income tax between the debtor and the estate. The same method used to allocate income must be used to allocate withheld income tax. For example, if one-sixth of the wages reported on Form W-2 for the calendar year ending December 31, 2005, was earned after the commencement of the case and must therefore be included in the estate's gross income, one-sixth of the withheld income tax reported on Form W-2 must be claimed as a credit on the estate's income tax return and five-sixths of the withheld income tax must be claimed as a credit on

the debtor's income tax return. *See* I.R.C. § 31(a).

.02 In some cases, persons filing information returns may report to the debtor gross income, gross proceeds, or other reportable payments that should have been reported to the bankruptcy estate using Forms 1099-INT, 1099-DIV, 1099-MISC, Schedule K-1 or other information returns. This may occur, for instance, if the debtor in possession fails to notify the payor of the bankruptcy in accordance with section 3.03. In these cases, the debtor in possession, or the trustee, must allocate the improperly reported income in a reasonable manner between the debtor and the estate. In general, the allocation must ensure that any income (and any income tax withheld) attributable to the post-petition period is reported on the estate's return, and any income (and income tax withheld) attributable to the pre-petition period is reported on the debtor's return. The allocations, however,

must be in accordance with all the rules stated in sections 2.09, 2.10, 2.11, 2.12, and 2.13 of this notice.

.03 The debtor must attach a statement to his or her income tax return stating that he or she filed a Chapter 11 bankruptcy case. The statement must reflect the foregoing allocations of income and withheld income tax and must describe the method used to allocate income and withheld tax between the debtor and the estate. The statement should list the filing date of the bankruptcy case, the bankruptcy court in which the case is pending, the bankruptcy court case number, and the bankruptcy estate's EIN. The debtor in possession or trustee must attach a similar statement to the income tax return of the estate.

.04 The following model statement may be used by debtors, debtors in possession and trustees in complying with the requirements of section 6 of this notice:

#### Notice 2006-83 Statement

##### *Pending Bankruptcy Case*

The taxpayer, \_\_\_\_\_, filed a bankruptcy petition under Chapter 11 of the Bankruptcy Code on \_\_\_\_\_ in the Bankruptcy Court for the \_\_\_\_\_ District of \_\_\_\_\_. The bankruptcy court case number is \_\_\_\_\_. Gross income, and withheld federal income tax, reported on Form W-2, Forms 1099, K-1, Schedule K-1, and other information returns received under the taxpayer's name and social security number (or other taxpayer identification number) are allocated between the taxpayer and the bankruptcy estate (EIN\_\_\_\_-\_\_\_\_) as follows, using [*describe allocation method*]:

<i>Year</i>	<i>Taxpayer</i>	<i>Estate</i>
1. Form W-2 from _____ Co.	\$_____	\$_____
Withheld income tax shown on Form W-2	\$_____	\$_____
2. Form 1099-INT from _____ Bank	\$_____	\$_____
Withheld income tax (if any) shown on Form 1099-INT	\$_____	\$_____
3. Form 1099-DIV from _____ Co.	\$_____	\$_____
Withheld income tax (if any) shown on Form 1099-DIV	\$_____	\$_____
4. Form 1099-MISC from _____ Co.	\$_____	\$_____
Withheld income tax (if any) shown on Form 1099-MISC	\$_____	\$_____

## Section 7. REQUEST FOR COMMENTS

.01 The IRS and the Treasury Department are aware that further guidance may be needed as a consequence of the enactment of section 1115 and request comments from the public.

.02 In particular, section 1115 does not address whether, or to what extent, the income earned by the debtor from services performed after confirmation of the Chapter 11 plan is property of the estate or property of the debtor. Nor does section 1115 address whether, or to what extent, property of the estate retains its character as such after it vests in the debtor upon plan confirmation under section 1141(b) of the Bankruptcy Code. Courts have addressed the effects of plan confirmation on the scope and extent of the Chapter 13 estate under the analogous provisions of that Chapter, but the courts have reached varying and conflicting results. See, for example, *Telfair v. First Union Mortgage Corp.*, 216 F.3d 1333, 1340 (11<sup>th</sup> Cir. 2000) (describing the estate termination approach, the preservation approach, and the transformation approach) and *Barbosa v. Soloman*, 235 F.3d 31, 36, 37 (1<sup>st</sup> Cir. 2000) (describing a fourth, hybrid, approach). Comments are requested as to the proper treatment of post-confirmation income, given the conflicting holdings under analogous provisions of Chapter 13. Comments are also requested as to whether the terms of the Chapter 11 plan and the order confirming the plan may affect the taxation of post-confirmation earnings of the debtor and post-confirmation income on property of the estate.

.03 Section 3.02 of this notice addresses the tax consequences of compensation that a debtor in possession receives from the estate for managing or operating a trade or business carried on by the debtor before the commencement of the bankruptcy case. In some cases, however, the estate might not conduct a trade or business because the debtor was the employee of a third party before the commencement of the case and continues as an employee post-petition. Comments are requested on the tax treatment to the estate and the debtor of the portion of the post-petition compensation from a third party employer that the bankruptcy court allows the debtor to retain to pay for the debtor's personal

or living expenses. In particular, comments are requested regarding whether such post-petition compensation is subject to double taxation as gross income to the debtor under section 61 and earnings under section 1115(a)(2) of the Bankruptcy Code includible in the estate's gross income under section 1398(e)(1), without a corresponding deduction for the estate.

.04 Comments should be submitted on these and other relevant issues in writing on or before December 1, 2006, to the Internal Revenue Service, P.O. Box 7604, Washington, D.C. 20044, Attn: CC:PA:CBS (Notice 2006-83). Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at Room 105, First Floor, Internal Revenue Service, 1901 S. Bell Street, Jeff Davis Highway, Arlington, Va., Attn: CC:PA:CBS (Notice 2006-83). Submissions may also be sent electronically via the internet to the following email address: [Notice.comments@irs.counsel.treas.gov](mailto:Notice.comments@irs.counsel.treas.gov). Include the notice number (Notice 2006-83) in the subject line. All comments will be available for public inspection and copying.

## Section 8. PAPERWORK REDUCTION ACT

.01 The collection of information in the notice has been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-2033.

.02 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 OMB control number.

.03 The collection of information in the notice is in section 6 of this notice entitled "Allocation of Income and Credits on Information Returns and Required Statement for Returns." The collection of information is required for compliance with I.R.C. § 1398. The collection of information is required to comply with the Internal Revenue Code. The likely respondents are individuals and their chapter 11 bankruptcy estates.

.04 The estimated total annual reporting burden is 1,500 hours. The estimated annual burden per respondent is 1/2 hour. The

estimated number of respondents is 3,000. The estimated frequency of responses is annually.

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

## Section 9. DRAFTING INFORMATION

The principal author of this notice is William F. Conroy of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice, contact William F. Conroy at (202) 622-3620 (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 tax liability.*

## Rev. Proc. 2006-39

### SECTION 1. PURPOSE

This revenue procedure provides the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under section 842(b) of the Internal Revenue Code for taxable years beginning after December 31, 2004. Instructions are provided for computing foreign insurance companies' liabilities for the estimated tax and installment payments of estimated tax for taxable years beginning after December 31, 2004. For more specific guidance regarding the computation of the amount of net investment income to be included by a foreign insurance company on its U.S. income tax return, see Notice 89-96, 1989-2 C.B. 417. For the domestic asset/liability percentage and domestic investment yield, as well as instructions for computing foreign insurance companies' liabilities for estimated tax and installment payments of estimated tax for taxable years beginning after December 31, 2003, see Rev. Proc. 2005-64, 2005-36 I.R.B. 492.

## SECTION 2. CHANGES

.01 DOMESTIC ASSET/LIABILITY PERCENTAGES FOR 2005. The Secretary determines the domestic asset/liability percentage separately for life insurance companies and property and liability insurance companies. For the first taxable year beginning after December 31, 2004, the relevant domestic asset/liability percentages are:

133.5 percent for foreign life insurance companies, and

181.6 percent for foreign property and liability insurance companies.

.02 DOMESTIC INVESTMENT YIELDS FOR 2005. The Secretary is required to prescribe separate domestic investment yields for foreign life insurance companies and for foreign property and liability insurance companies. For the first taxable year beginning after December 31, 2004, the relevant domestic investment yields are:

5.8 percent for foreign life insurance companies, and

3.8 percent for foreign property and liability insurance companies.

.03 SOURCE OF DATA FOR 2005. The section 842(b) percentages to be used for the 2005 tax year are based on tax return data following the same methodology used for the 2004 year.

## SECTION 3. APPLICATION – ESTIMATED TAXES

To compute estimated tax and the installment payments of estimated tax due for taxable years beginning after December 31, 2004, a foreign insurance company must compute its estimated tax payments by adding to its income other than net investment income the greater of (i) its net investment income as determined under section 842(b)(5), that is actually effectively connected with the conduct of a trade or business within the United States for the relevant period, or (ii) the minimum effectively connected net investment income under section 842(b) that would result from using the most recently available domestic asset/liability percentage and domestic investment yield. Thus, for installment payments due after the publication of this revenue procedure, the domestic asset/liability percentages and the domestic investment yields provided in this revenue procedure must be used to compute the minimum effectively connected net investment income. However, if the due date of an installment is less than 20 days after the date this revenue procedure is published in the Internal Revenue Bulletin, the asset/liability percentages and domestic investment yields provided in Rev. Proc. 2005–64 may be used to compute the mini-

mum effectively connected net investment income for such installment. For further guidance in computing estimated tax, see Notice 89–96.

## SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning after December 31, 2004.

## SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Gregory A. Spring of the Office of Chief Counsel (International). For further information regarding this revenue procedure, contact Gregory A. Spring at (202) 622–3870 (not a toll-free call), or write to the Internal Revenue Service, Office of the Associate Chief Counsel (International), Attention: CC:INTL:BR5, 1111 Constitution Avenue, N.W., IR–4554, Washington, D.C. 20224.



## Part IV. Items of General Interest

### Notice of Proposed Rulemaking

#### Exclusion From Gross Income of Previously Taxed Earnings and Profits and Adjustments to Basis of Stock in Controlled Foreign Corporations and of Other Property

REG-121509-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance relating to the exclusion from gross income of previously taxed earnings and profits under section 959 of the Internal Revenue Code (Code) and related basis adjustments under section 961 of the Code. These regulations reflect relevant statutory changes made in years subsequent to 1983. These regulations also address a number of issues that the current section 959 and section 961 regulations do not clearly answer. These regulations, in general, will affect United States shareholders of controlled foreign corporations and their successors in interest.

DATES: Written or electronic comments and requests for a public hearing must be received by November 27, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-121509-00), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044 or send electronically, via the IRS Internet site at [www.irs.gov/reg](http://www.irs.gov/reg) or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-121509-00).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Ethan Atticks, (202) 622-3840; concerning submissions of comments, Kelly Banks, (202) 622-0392 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

#### Background

This document contains proposed amendments to 26 CFR Part 1 under sections 959, 961, and 1502. Section 959(a)(1) generally provides an exclusion from the gross income of a United States shareholder for distributions of earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in a United States shareholder's gross income under section 951(a). Section 959(a)(2) excludes from the gross income of a United States shareholder earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) which would, but for section 959(a)(2), be again included in gross income of a United States shareholder under section 951(a)(1)(B) as an amount determined under section 956 (section 956 amounts). Earnings and profits of a foreign corporation included in a United States shareholder's gross income under section 951(a) are referred to as previously taxed earnings and profits or previously taxed income (PTI).

Section 959(b) generally provides that for purposes of section 951(a), PTI shall not, when distributed through a chain of ownership described in section 958(a), be included in the gross income of a controlled foreign corporation (CFC) in such chain for purposes of the application of section 951(a) to such CFC.

Section 959(c) generally provides for the allocation of distributions by a foreign corporation to three different categories of the corporation's earnings and profits: (1) PTI attributable to section 956 amounts that are included in the gross income of a United States shareholder under section 951(a)(1)(B) and section 956 amounts that would have been so included but for section 959(a)(2), (2) PTI attributable to amounts included in gross income under section 951(a)(1)(A), and (3) other earnings and profits (non-PTI). Section 959(f) provides for the allocation of section 956 amounts first to PTI arising from a United States shareholder's income inclusions under section 951(a)(1)(A) and

then to non-PTI. In addition, section 959(f) provides a priority rule under which actual distributions of earnings and profits are taken into account before section 956 amounts.

Certain amounts are treated as amounts included in the gross income of a United States shareholder under section 951(a)(1)(A) for purposes of section 959. For example, section 959(e) generally provides that any amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 is treated for purposes of section 959 as an amount included in the gross income of such person under section 951(a)(1)(A).

Section 961 authorizes the Secretary of the Treasury to promulgate regulations adjusting the basis of stock in a foreign corporation, as well as the basis of other property by reason of which a United States person is considered under section 958(a) to own stock in a foreign corporation. Section 961(a) generally provides for an increase in a United States shareholder's basis in its CFC stock, or in the property by reason of which it is considered to own such stock, by the amount required to be included in its gross income under section 951(a) with respect to such stock.

Under section 961(b), and the regulations thereunder, when a United States person receives an amount which is excluded from gross income under section 959(a), the adjusted basis of the foreign corporation stock or the property by reason of which the shareholder is considered to own such stock is reduced by the amount of the exclusion. In addition, section 961(c) generally provides for regulations under which adjustments similar to those provided for under section 961(a) and (b) are made to the basis of stock in a CFC which is owned by another CFC (and certain other CFCs in the chain) for the purpose of determining the amount included under section 951 in the gross income of a United States shareholder.

Section 959 was enacted so that PTI is excluded from gross income and, thus, not taxed again when distributed by the foreign corporation. Moreover, section 959 effects the relevant gross income exclusion at the earliest possible point. Thus, the "allocation of distribution" rules of

section 959(c) ensure that distributions from the foreign corporation are to be paid first out of earnings and profits attributable to amounts that have been previously included in income by the United States shareholders. Accordingly, as a result of its section 951(a)(1) inclusion, a United States shareholder is made whole by receiving, without further U.S. tax, PTI attributable to its stock in a foreign corporation before it receives any taxable distributions from the foreign corporation. Section 961, which adjusts basis in the stock in a foreign corporation for PTI attributable to such stock, also ensures that PTI is not taxed twice if the stock in the foreign corporation is sold before the PTI is distributed.

The existing regulations under sections 959 and 961 were published in 1965. See T.D. 6795, 1965-1 C.B. 287. Minor amendments were made to the regulations in 1974, 1978, and 1983. See T.D. 7334, 1975-1 C.B. 246; T.D. 7545, 1978-1 C.B. 245; T.D. 7893, 1983-1 C.B. 132. The regulations have not been updated since 1983 to reflect relevant statutory changes in subsequent years. For example, section 959(e) (described above) was added by the Deficit Reduction Act of 1984 (Public Law 98-369). Section 304(b)(6) was enacted by the IRS Restructuring and Reform Act of 1998 (Public Law 105-206) and provides that in the case of a section 304 transaction in which the acquiring corporation or the issuing corporation is a foreign corporation, the Secretary of the Treasury is to prescribe regulations providing rules to prevent the multiple inclusion of any item in income and to provide appropriate basis adjustments, including rules modifying the application of sections 959 and 961. The determination of the amount includible in a United States shareholder's gross income as a result of a CFC's investments in United States property under section 956 was modified by the Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66). Congress enacted section 961(c) (described in this preamble) as part of the Taxpayer Relief Act of 1997 (Public Law 105-34) and further modified the provision in the Gulf Opportunity Zone Act of 2005 (Public Law 109-135). Section 986 was added to the Code by the Tax Reform Act of 1986 (Public Law 99-514) and provides that earnings and profits of foreign cor-

porations are maintained in the foreign corporation's functional currency and translated into United States dollars when taken into account by a United States person at the appropriate exchange rate specified in section 989.

Further, in addition to raising issues about the complexities of section 959 in cross-chain stock sales subject to section 304(a)(1), commentators and taxpayers have raised a number of other issues that the current section 959 regulations do not clearly answer. For example, issues have been raised about distributions of PTI through a chain of CFCs and the status of PTI when a United States shareholder's stock in a foreign corporation is sold to a foreign person. There are numerous other examples where the existing section 959 regulations simply do not provide sufficient guidance. As a result, additional regulatory guidance is needed to address these and other section 959 issues. In addition, the IRS and Treasury Department are currently studying the new section 954(c)(6) rule enacted by the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109-222), which generally provides for look-through treatment of payments between related CFCs under the foreign personal holding company rules of section 954(c), to determine whether that rule requires any additional regulatory guidance under section 959. Any such guidance will be included in a subsequent project.

### **Explanation of Provisions**

These proposed regulations provide guidance with respect to a number of issues that are not specifically addressed in the current regulations and also resolve some of the complexities raised regarding the application of sections 959 and 961. The guidance needed to answer open issues under sections 959 and 961 is intended to be consistent with the legislative intent of avoiding double taxation and allowing United States persons to receive the full benefit of their PTI at the earliest possible time.

In order to carry out this legislative intent, these regulations propose new rules that are primarily based on maintaining shareholder accounts for PTI. As described in this preamble, maintaining shareholder accounts for PTI will better

ensure that taxpayers are able to receive distributions of PTI before receiving taxable distributions, provide consistency for treatment of PTI by taxpayers, and provide more rational and clear rules for resolving many of the issues that have been raised by taxpayers since the current section 959 regulations were issued. Under the proposed rules, earnings and profits will still be maintained at the foreign corporation level in the PTI and non-PTI categories described in section 959(c) on an aggregate basis with respect to all of the foreign corporation's outstanding shares.

The proposed rules also would modify the current regulations to reflect amendments to the law since 1965, such as the addition of section 959(e) and section 961(c), and the modification of sections 304 and 956. Minor changes have also been proposed to reflect changes in IRS titles and organizational units used in the current regulations.

### *A. Shareholder-level Exclusion Under Section 959(a)*

#### *1. In general*

Section 959 provides rules for the exclusion from gross income of PTI. Prop. Reg. §1.959-1 describes the scope and purpose of the proposed regulations under section 959 in paragraph (a) and provides definitions in paragraph (b). Paragraph (c) generally provides for the exclusion from a covered shareholder's gross income of a distribution or section 956 amount based upon the amount of adjustments made to a shareholder's PTI accounts with respect to the relevant stock under Prop. Reg. §1.959-3 because of that distribution or section 956 amount, as discussed below. A covered shareholder is defined to mean a person who is (1) a United States person who owns stock (within the meaning of section 958(a)) in a foreign corporation and who has had a section 951(a) inclusion with respect to its stock in such corporation, (2) a "successor in interest" (defined in this preamble), or (3) a corporation that is not described in (1) or (2) and that owns stock (within the meaning of section 958(a)) in a foreign corporation in which another corporation is a covered shareholder described in (1) or (2), if both corporations are members of the same consolidated group.

## 2. Shareholder PTI accounts

Prop. Reg. §1.959-1(d)(1) requires each covered shareholder of a foreign corporation to maintain a PTI account for each share of stock in a foreign corporation that the shareholder owns directly or indirectly under section 958(a). Although the PTI account is share specific, as a matter of administrative convenience, Prop. Reg. §1.959-1(d)(1) permits a shareholder to maintain the account with respect to an entire block of stock in a foreign corporation if the PTI attributable to each share in the block is the same. For a discussion of the rules for maintaining a PTI account, see Part C of this discussion.

## 3. Successors in interest

Section 959(a) extends the exclusion from gross income for PTI to any United States person who acquires from any person any portion of the interest of a United States shareholder (as the term is defined in section 951(b) or section 953(c)(1)(A)) in a foreign corporation, but only to the extent of that portion and subject to such proof of the identity of such interest as the Secretary of the Treasury may by regulations prescribe. Consequently, Prop. Reg. §1.959-1(d)(2)(i) provides that a transferee of stock in a foreign corporation acquires the PTI account of the transferor for such stock and may exclude PTI from gross income under section 959(a) by reference to the PTI account for the stock acquired if the transferee is a United States person that can prove the right to the exclusion (successor in interest).

In order to establish a United States person's right to the exclusion, the proposed regulations provide that a person must attach a statement to its return that provides that it is excluding amounts from gross income because it is a successor in interest and that provides the name of the foreign corporation. Further, a person must be prepared to provide, within 30 days upon the request of the Director of Field Operations, certain additional information (*e.g.*, evidence showing that the earnings and profits for which an exclusion is claimed are PTI and that such amounts were not previously excluded from the gross income of a United States person). The information that may be required under these proposed regulations remains substantially

unchanged from the information that is currently required to be included in a statement with the United States person's return under §1.959-1(d).

Moreover, Prop. Reg. §1.959-1(d)(2)(ii) provides that the amount of the PTI account for stock that is transferred to someone who is not a successor in interest (*e.g.*, a foreign person) is preserved unchanged during the period of such person's ownership of such stock. However, section 959(a) extends the section 959(a) exclusion to a United States person who acquires a United States shareholder's interest in a foreign corporation from any person. Accordingly, Prop. Reg. §1.959-1(d)(2)(i) provides that if a United States person acquires stock in a foreign corporation from any person, including a person that is not a successor in interest, such as a foreign person, and the United States person qualifies as a successor in interest, the United States person acquires the PTI account attributable to the foreign corporation stock acquired and may exclude PTI from gross income under section 959(a) by reference to the PTI account for such stock.

### B. CFC-level Exclusion Under Section 959(b)

Section 959(b) provides an exclusion pursuant to which the earnings and profits of a CFC (lower-tier CFC) attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be also included in the gross income of the CFC receiving the distribution (upper-tier CFC) in such chain for purposes of the application of section 951(a) to such upper-tier CFC with respect to such United States shareholder. Prop. Reg. §1.959-2 contains rules relating to the section 959(b) exclusion. These rules are intended to reflect the holding of Rev. Rul. 82-16, 1982-1 C.B. 106, as well as to provide guidance regarding cross-chain sales of stock in a foreign corporation by a CFC subject to section 304(a)(1).

In Rev. Rul. 82-16, an upper-tier CFC, 70 percent owned by a United States shareholder (USP) and 30 percent owned by a foreign person, received a distribution of \$200x of earnings and profits from

a lower-tier CFC wholly-owned by the upper-tier CFC. The lower-tier CFC had earned \$100x of subpart F income for the year of the distribution (\$70x of which was included in USP's gross income under section 951(a)) and a \$100x of non-subpart F income. The ruling held that \$100x, rather than \$70x, was excluded from the gross income of the upper-tier CFC under section 959(b). If only \$70x were excluded, USP would be required to include in gross income \$21x of subpart F income with respect to the remaining \$30x included in the upper-tier CFC's gross income, resulting in a total inclusion in USP's gross income of \$91x ( $(70\% \times \$30x) + (70\% \times \$100x)$ ).

Prop. Reg. §1.959-2(a) addresses the issue raised in Rev. Rul. 82-16, and accordingly, provides that the amount of the exclusion provided under section 959(b) is the entire amount distributed by the lower-tier CFC to the upper-tier CFC that gave rise (in whole or in part) to an adjustment of the United States shareholder's PTI accounts with respect to the stock it owns (within the meaning of section 958(a)) in the lower- and upper-tier CFC under Prop. Reg. §1.959-3(e)(3) (discussed in this preamble). This amount shall not exceed the earnings and profits of the distributor CFC attributable to amounts described in section 951(a). Such amount is not limited to the amount of the adjustment to the United States shareholder's PTI account.

For example, under the facts of Rev. Rul. 82-16, the amount excluded from the upper-tier CFC's gross income for purposes of applying section 951(a) to USP under Prop. Reg. §1.959-2(a) is \$100x. That is, the entire amount of the earnings and profits distributed by the lower-tier CFC that were attributable to amounts described in section 951(a) and that caused an adjustment to USP's PTI accounts in both the upper- and lower-tier CFCs under Prop. Reg. §1.959-3(e)(3).

Prop. Reg. §1.959-2(a) produces results consistent with Rev. Rul. 82-16, while ensuring that section 959(b) does not inappropriately prevent taxation under section 951(a) of a United States shareholder that has acquired stock in a CFC from a person that was not taxed on the subpart F income of a lower-tier CFC in the year such income was earned (*e.g.*, a foreign person). For example, assume the same facts as those of Rev. Rul. 82-16,

except that: (1) the subpart F income was earned by the lower-tier CFC in year 1, (2) another United States shareholder (DC) acquired the 30 percent interest in the upper-tier CFC in year 2 from the foreign person with a zero PTI account, and (3) the lower-tier CFC did not distribute any property until year 3. Under Prop. Reg. §1.959-2(a), the section 959(b) exclusion for the upper-tier CFC for purposes of calculating USP's section 951(a) inclusion is still \$100x. In contrast, Prop. Reg. §1.959-2(a) provides that the section 959(b) exclusion for the upper-tier CFC for purposes of determining DC's section 951(a) inclusion is zero because none of the earnings and profits distributed were attributable to amounts included in income under section 951(a) with respect to DC or the person to whom DC is a successor in interest. Therefore, DC may have an income inclusion under section 951(a).

In addition, Prop. Reg. §1.959-2(b) provides guidance with respect to the application of section 959(b) in the context of stock sales subject to section 304(a)(1) where the selling corporation is a CFC. The proposed regulations clarify that in the case of a deemed redemption resulting from a transaction described in section 304(a)(1) in which earnings and profits of an acquiring foreign corporation or an acquired foreign corporation or both are deemed distributed to a selling CFC, the selling CFC is deemed for purposes of section 959(b) to receive such distributions through a chain of ownership described under section 958(a).

### C. Maintenance of PTI Accounts

The proposed regulations contain detailed rules regarding the maintenance of shareholder PTI accounts and the maintenance of pools of PTI and non-PTI earnings and profits with respect to a foreign corporation, including rules for adjusting PTI accounts as a result of certain transactions. In addition, the proposed regulations provide rules for covered shareholders that have more than one share of stock in a foreign corporation and covered shareholders that are members of a consolidated group.

#### 1. Shareholder-level accounting of PTI

The proposed regulations provide that a covered shareholder's PTI account with respect to its stock in a foreign corpora-

tion shall identify the amounts included in gross income by a United States shareholder under section 951(a)(1)(A) with respect to the stock (PTI described in section 959(c)(2)), and amounts that are included in the gross income of a United States shareholder under section 951(a)(1)(B) and section 956 amounts that would have been so included but for section 959(a)(2) (PTI described in section 959(c)(1)) by such shareholder that owns the stock or by a successor in interest. A shareholder account must also reflect these amounts in the functional currency of the foreign corporation and the annual dollar basis of each category of PTI in the account.

#### 2. Corporate-level accounting of PTI

The proposed regulations also provide that separate aggregate categories (with respect to all of the shareholders of a foreign corporation) of PTI described in section 959(c)(1) and section 959(c)(2) and non-PTI shall be maintained with respect to foreign corporations. These categories of earnings and profits of a foreign corporation shall be maintained in the functional currency of the foreign corporation.

The proposed regulations reflect the basic allocation rules under section 959(c) and (e). Those rules provide that distributions are considered to be made on a last-in first-out basis under section 316(a), first from any PTI described in section 959(c)(1), then from PTI described in section 959(c)(2), and finally from non-PTI earnings and profits. In addition, section 956 amounts are allocated first to section 959(c)(2) earnings and profits and then to non-PTI earnings and profits. Consequently, PTI resulting from section 956 amounts in a prior year cannot exclude section 956 amounts in a later year from otherwise being included in a United States shareholder's gross income under section 951(a)(1)(B).

The proposed regulations also provide that these allocations to PTI are made in conjunction with the shareholder-level adjustments to shareholder-level PTI accounts. In addition, any adjustments to earnings and profits required under section 312 or other sections of the Code or Treasury regulations shall generally be made only to non-PTI.

#### 3. Foreign currency and foreign tax credit rules

The proposed regulations also contain several rules that reflect the significant changes made to the foreign currency translation rules since the existing section 959 regulations were issued. The proposed regulations also contain rules regarding the foreign tax credit rules relating to PTI.

##### a. Dollar basis pooling election

The proposed regulations provide that a shareholder account must reflect the annual dollar basis of each category of PTI in the account. However, Prop. Reg. §1.959-3(b)(2)(ii) allows taxpayers to elect to treat distributions as being made from a single pool of post-1986 PTI for purposes of computing foreign currency gain or loss under section 986(c) and basis adjustments under section 961 with respect to distributions of PTI. Thus, the reduction of the basis of shares in a foreign corporation and the foreign currency gain (or loss) attributable to a PTI distribution may both be determined by assigning a *pro rata* portion of the shareholder's aggregate dollar basis in its PTI account to a distribution of PTI. Notice 88-71, 1988-2 C.B. 374, provided that regulations would adopt this method. The proposed regulations would make this pooled approach available to taxpayers for purposes of section 986(c) at the taxpayer's election and provide guidance as to how this election is made. The proposed regulations provide that the election is made by using a dollar basis pool to compute foreign currency gain or loss under section 986(c) with respect to distributions of PTI of a foreign corporation, or to compute gain or loss with respect to its stock in the foreign corporation, whichever occurs first. Any subsequent change in the taxpayer's method of assigning dollar basis may only be made with the consent of the Commissioner.

##### b. Taxes and other expenses attributable to PTI

Prop. Reg. §1.959-3(c) provides that the corporate-level and shareholder-level PTI accounts are reduced by the functional currency amount of any income, war profits, or excess profits taxes imposed by

any foreign country or a possession of the United States on or with respect to PTI as it is distributed by a foreign corporation to another foreign corporation through a chain of ownership described in section 958(a). The proposed regulations further provide that such taxes are not added to the foreign corporation's post-1986 foreign income taxes pool, which is maintained with respect to the foreign corporation's post-1986 undistributed earnings. Rather, such taxes are maintained in a separate account and allowed as a credit pursuant to section 960(a)(3) when the associated PTI is distributed to a United States shareholder (or its successor in interest). This rule ensures that amounts previously included in income that are used to pay creditable foreign taxes and so are unavailable for distribution to covered shareholders reduce the amount of PTI available for distribution but may be claimed as a foreign tax credit at the appropriate time. The proposed regulations also provide for corresponding adjustments to the covered shareholder's dollar basis of the PTI account.

Prop. Reg. §1.959-3(d) provides that no expenses of a foreign corporation, other than creditable foreign income taxes described in Prop. Reg. §1.959-3(c), shall be allocated and apportioned to reduce PTI. By allocating all such expenses to non-PTI, this rule preserves the amount of PTI that may be distributed to a United States shareholder (or its successor in interest) in a non-taxable manner.

#### 4. *Adjustment of shareholder PTI accounts*

The proposed regulations generally provide rules for the adjustment of a covered shareholder's PTI account upon an inclusion of income by the shareholder under section 951, an actual distribution of earnings and profits to the shareholder, or a determination of a section 956 amount with respect to the shareholder. The proposed regulations provide that the adjustment of PTI accounts occur according to the ordering rules of section 959 to determine the tax consequences of the various events. For purposes of determining the tax consequences to a covered shareholder in a foreign corporation, the proposed regulations provide that with respect to a foreign corporation's taxable year, and

for the taxable year of the covered shareholder in which or with which such taxable year of the foreign corporation ends, the following events are taken into account in the following order: (1) the covered shareholder's inclusion of subpart F income or other amounts in gross income under section 951(a)(1)(A) for a taxable year; (2) any actual distributions of current or accumulated earnings and profits by a foreign corporation during the year, including redemptions treated as distributions of property to which section 301 applies pursuant to section 302(d); and (3) any investments in United States property by a CFC during the year resulting in a section 956 amount for one or more United States shareholders for the year. For purposes of the proposed regulations, amounts included in the gross income of any person as a dividend under section 1248(a) or (f) are generally treated as section 951(a)(1)(A) inclusions.

Thus, under Prop. Reg. §1.959-3(e)(2), at the end of the foreign corporation's taxable year, a shareholder's PTI account is first adjusted upward by the amount of any subpart F income included in gross income by the shareholder under section 951(a) with respect to the shareholder's stock in the foreign corporation. Second, a shareholder's PTI account is adjusted downward by the amount of any distributions of PTI to the shareholder with respect to the stock during the year. However, a PTI account can never be reduced below zero. Third, to the extent that any section 956 amount for the year is equal to (or less than) the amount of PTI described in section 959(c)(2), an amount of such PTI equal to the section 956 amount is reclassified as PTI described in section 959(c)(1), but does not decrease the shareholder's PTI account. Finally, the shareholder's PTI account is adjusted upward by any section 956 amount in excess of the PTI described in section 959(c)(2) for the year. Corresponding adjustments are made to the dollar basis of the PTI account.

This sequence of adjustments may be affected by the PTI sharing rules discussed below. Although the sharing rules are described in greater detail in Prop. Reg. §§1.959-3(f) and (g), the order of the adjustments described in these sections are provided for in the steps described in Prop. Reg. §1.959-3(e)(2).

The amount of a downward adjustment to the covered shareholder's PTI account under the second step described above is excluded from the shareholder's gross income under section 959(a)(1) and Prop. Reg. §1.959-1(c)(1). Similarly, the amount of section 959(c)(2) PTI which is reclassified as section 959(c)(1) PTI under the third step described above is excluded from the covered shareholder's gross income under section 959(a)(2) and Prop. Reg. §1.959-1(c)(2).

#### 5. *Adjustment to PTI accounts upon distributions to intermediary CFCs*

Where stock in a lower-tier CFC is owned indirectly by a United States shareholder (or successor in interest) through one or more upper-tier CFCs in a chain of ownership under section 958(a), the shareholder's PTI accounts with respect to stock in the relevant foreign corporations in the chain must be adjusted when the lower-tier CFC makes a distribution of PTI to an upper-tier CFC in the chain. Prop. Reg. §1.959-3(e)(3) provides that the shareholder's PTI account with respect to stock in the distributing foreign corporation is decreased by the amount of PTI distributed with respect to such stock, and the shareholder's PTI account with respect to stock in the recipient foreign corporation is increased by the same amount (in addition to being increased by any non-PTI portion of the distribution that results in an inclusion in the shareholder's gross income under section 951(a) as subpart F income of the receiving CFC). Prop. Reg. §1.959-3(e)(3) provides a spot rate translation convention for cases in which the distributing and receiving corporations use different functional currencies.

#### 6. *Effect of deficits in earnings and profits*

Prop. Reg. §1.959-3(e)(5) provides that a shareholder's PTI account is not adjusted to take into account any deficit in earnings and profits of the corporation for the taxable year. Deficits will reduce only the non-PTI of the corporation under section 312.

#### 7. *Distribution in excess of the PTI account*

Under Prop. Reg. §1.959-3(e)(5), when a foreign corporation distributes to

a shareholder an amount exceeding the PTI account with respect to the relevant stock, the treatment of the excess amount depends on the facts and circumstances. Subject to the PTI sharing rules discussed below, the excess amount of a distribution generally is treated as a dividend under section 316 to the extent of the distributing corporation's non-PTI, and thereafter as a return of capital (reducing the shareholder's basis in its stock in the foreign corporation) under section 301(c)(2). Any portion of the distribution remaining after the shareholder's basis of the stock in the foreign corporation is reduced to zero is treated as capital gain under section 301(c)(3).

#### 8. PTI sharing rules

The purpose of section 959 is to prevent double taxation of amounts that have been previously included in gross income by a United States shareholder under section 951(a) and, importantly, to prevent such double taxation at the earliest possible time. Section 951 subjects a United States shareholder to tax on undistributed income of a CFC, so the ordering rule of section 959(c) effectuates this statutory purpose by treating actual distributions to the shareholder as coming first out of PTI. As one of the goals of section 959 is to treat distributions as first coming from PTI, the IRS and Treasury Department believe that a United States shareholder (or successor in interest) should be entitled to exclude from gross income under section 959(a) all of a foreign corporation's distributions of earnings and profits and section 956 amounts to the extent of PTI associated with any of the United States person's stock in the foreign corporation, before that person is required to include additional distributions of earnings and profits or section 956 amounts of the foreign corporation in gross income.

The IRS and Treasury Department believe that similar rules should apply with respect to members of a consolidated group. Although the taxation of a consolidated group represents a hybrid of single and separate entity treatment, consolidated attribute utilization is generally based on single entity treatment. For example, when determining consolidated taxable income for a given year, subject to certain limitations, the group

is entitled to offset its income with any consolidated net operating losses that are carried forward to such year (regardless of which member or members recognized the income or incurred the losses). Given the broad regulatory authority of section 1502 and the statutory mandate in section 959 to allow United States shareholders (or successors in interest) to recover PTI at the earliest possible time, the IRS and Treasury Department believe that PTI is an attribute for which single entity treatment of United States consolidated groups is appropriate. As a result, the IRS and Treasury Department have concluded that a shareholder of a foreign corporation that is a member of a consolidated group should be entitled to exclude from gross income under section 959(a) all of a foreign corporation's distributions of earnings and profits, and section 956 amounts, to the extent of PTI associated with any stock in the foreign corporation owned by any member of the consolidated group (with appropriate adjustments). Therefore, the proposed regulations provide for sharing of PTI between accounts of different members of a consolidated group in a manner similar to the sharing of PTI between multiple accounts of a single shareholder, as described below.

##### a. Shareholder with multiple PTI accounts

Prop. Reg. §1.959-3(f) provides a special rule that applies when a United States shareholder has more than one PTI account with respect to stock in a foreign corporation, and during its taxable year, the foreign corporation distributes earnings and profits in an amount that exceeds one or more of such PTI accounts. In that case, the shareholder's PTI accounts with respect to all of its other stock in the foreign corporation that it owns at the end of the foreign corporation's taxable year shall be reduced, in the aggregate, by the amount of the excess, on a *pro rata* basis by reference to the level of such PTI accounts (after such PTI accounts have first been adjusted to reflect any distributions of earnings and profits with respect to those blocks of stock).

The aggregate reduction in such PTI accounts produces a corresponding increase in the PTI account that would have been exceeded by the amount distributed but for the operation of this sharing rule. That

PTI account is then reduced to zero to reflect the amount of earnings and profits distributed with respect to that block of stock during the year.

Similarly, if the section 959(c)(2) portion of a PTI account for a share in a foreign corporation is exceeded by the section 956 amount attributable to the share, the aggregate amount of the section 959(c)(2) portion of the PTI accounts for all other stock of the foreign corporation owned by the shareholder on the last day of the foreign corporation's taxable year is available for purposes of excluding the section 956 amount from gross income under section 959(a)(2).

##### b. Shareholder that is a member of a consolidated group

Prop. Reg. §1.959-3(g) provides similar sharing rules where stock in a foreign corporation is owned by two or more members of a consolidated group. For purposes of administrative convenience, however, this rule focuses on whether the shareholders are members of the same consolidated group at the end of the foreign corporation's taxable year and not at the time the PTI in question was generated. Specifically, if the total amount of a United States shareholder's PTI account or accounts for stock in a foreign corporation is exceeded by the amount of earnings and profits distributed by the corporation to the shareholder during the year, the PTI accounts of other members of the shareholder's consolidated group that own stock in the corporation are decreased on a *pro rata* basis (after adjustment) and the shareholder's PTI accounts or account, as the case may be, will be correspondingly increased and then adjusted downward to zero.

Similarly, if the total amount of the section 959(c)(2) portion of a shareholder's PTI account or accounts for stock in a foreign corporation is exceeded by the shareholder's section 956 amount for the year, the aggregate amount of the section 959(c)(2) portions of the PTI accounts of other member's of the shareholder's consolidated group at the end of the foreign corporation's taxable year that own stock in the foreign corporation will be available to the shareholder for purposes of excluding the section 956 amount from gross income under section 959(a)(2).

## 9. *Redemptions, including section 304 transactions*

The proposed regulations provide rules for the adjustment of PTI accounts and the effect on the corporation's non-PTI when a foreign corporation redeems its stock. The effect of a distribution in redemption of stock (redemption distribution) depends on whether the redemption distribution is treated as a payment in exchange for the stock under sections 302(a) or 303, or as a distribution of property to which section 301 applies pursuant to section 302(d).

### a. *Redemptions treated as sales or exchanges*

If a redemption distribution is treated as a sale or exchange, generally the amount chargeable to the earnings and profits of the redeeming corporation is limited by section 312(n)(7) to a ratable share of the earnings and profits. Where the redeeming corporation is a foreign corporation and there is a PTI account with respect to the redeemed stock, the proposed regulations provide that section 312(n)(7) is applied by limiting the reduction of the redeeming corporation's earnings and profits to an amount which does not exceed the sum of (1) the amount in the PTI account for the redeemed stock and (2) a ratable share of the corporation's non-PTI attributable to the redeemed shares, if any. This sum first reduces the PTI account with respect to the redeemed stock and then reduces the corporation's non-PTI.

The IRS and Treasury Department believe that, in the case where a foreign corporation redeems stock in a transaction treated as a sale or exchange for an amount that is less than the PTI account for that stock, it would be inappropriate to transfer the remainder of the PTI account to any other PTI accounts with respect to stock in the foreign corporation. Under section 961(a) and the regulations thereunder, the basis of stock in a foreign corporation is increased by the amount included in the shareholder's gross income under section 951(a), which is reflected in the PTI account with respect to such stock. The shareholder recovers this increase in basis upon a sale of the stock, preventing the shareholder from suffering double taxation on gain attributable to PTI (or in appropriate cases enabling the shareholder

to recognize a loss). Consequently, under the proposed regulations, the remainder of the PTI account in the situation described above is not transferred to any other PTI account because it was already accounted for in the treatment of the redemption as a sale or exchange. Any corporate-level PTI attributable to the redeemed stock that remains after the reduction under section 312(n)(7) loses its character as PTI and is reclassified as non-PTI of the corporation. The IRS and Treasury Department believe that because the redeemed shareholder is able to use the loss resulting from the redemption to offset other income, its excess PTI must become other earnings and profits that remain with the foreign corporation so that those earnings and profits can be subject to tax.

### b. *Redemptions treated as section 301 distributions*

If, under section 302(d), a redemption distribution is treated as a distribution of property to which section 301 applies, the proposed regulations provide that the rules of Prop. Reg. §§1.959-1 and -3 shall apply in the same manner as they do to any other distribution to which section 301(c) applies. The PTI account with respect to the redeemed stock is reduced by the amount of the redemption distribution. If the redemption distribution exceeds such PTI account, the sharing rules described above regarding nonredemptive distributions of earnings and profits will be applicable. If, instead, the PTI account with respect to the redeemed shares exceeds the amount of the redemption distribution, the excess PTI is reallocated to the PTI accounts with respect to the remaining stock in the foreign corporation in a manner consistent with, and in proportion to, the proper adjustments of the basis in the remaining shares of the foreign corporation pursuant to §1.302-2(c). Accordingly, the proposed regulations also require proper adjustment of the basis of the shareholder's remaining stock in the redeeming corporation, and of stock in the redeeming corporation held by related persons (not limited to members of the shareholder's consolidated group).

### c. *Deemed redemptions under section 304*

With respect to amounts paid to acquire stock in a transaction described in section

304(a)(1) and to which section 301(c) applies, the rules of Prop. Reg. §§1.959-1 and -3 shall apply in the same manner as they do to any other distribution to which section 301(c) applies. As discussed below, the sharing rules described above are applicable to such redemption distributions that are treated as distributions of property to which section 301 applies. In addition, a covered shareholder receiving such a distribution of earnings and profits shall have a PTI account with respect to the stock of each foreign corporation deemed to have distributed its earnings and profits under section 304(b)(2).

The Senate Report on the IRS Restructuring and Reform Act of 1998 states with respect to the Secretary's authority to prescribe regulations resulting from the enactment of section 304(b)(6), "[i]t is expected that such regulations will provide for an exclusion from income for distributions from earnings and profits of the acquiring corporation and the issuing corporation that represent previously taxed income under subpart F. It further is expected that such regulations will provide for appropriate adjustments to the basis of stock held by the corporation treated as receiving the distribution or by the corporation that had the prior inclusion with respect to the previously taxed income." S. Rep. No. 105-174 at 179 (1998). The Conference agreement on the Act follows the Senate amendment. H.R. Conf. Rep. No. 105-599 (1998).

In the case where members of a United States consolidated group own stock in the issuing corporation and the acquiring corporation in a section 304(a)(1) transaction, the PTI accounting and sharing rules are intended to prevent double taxation of PTI, as intended by Congress in enacting sections 304(b)(6) and 959. A lower-tier, cross-chain acquisition of stock is generally subject to section 304(a)(1) and the transferor is treated as having transferred the stock in the issuing corporation to the acquiring corporation in exchange for stock in the acquiring corporation in a transaction to which section 351(a) applies. The acquiring corporation is treated as having redeemed those shares pursuant to a redemption distribution to which section 301 applies. As a result, in accordance with these regulations, a PTI account with respect to the stock in the foreign corporation that is treated as re-

deemed under section 304(a)(1) would be considered to arise at the time of the transaction. Any PTI accounts with respect to stock in the foreign corporation owned by other members of the shareholder's consolidated group would be reduced, and the PTI account of the redeemed shareholder increased (and then reduced to zero), under the PTI sharing rules described above.

#### D. Basis Adjustments

The proposed regulations contain corresponding amendments to the regulations under section 961. These proposed regulations generally provide for increases and reductions in the basis of foreign corporation stock or other property through which foreign corporation stock is owned which match the increases and reductions in the PTI account with respect to such stock under the section 959 proposed regulations. The proposed regulations provide translation conventions for determining dollar basis adjustments under section 961 as a result of inclusions under section 951(a), distributions, and the foreign income taxes imposed on PTI as it is distributed through tiers of foreign corporations.

The proposed regulations also implement section 961(c) by providing for adjustments to the basis of stock in a CFC that is held by another CFC in a chain of ownership described in section 958(a) for the purpose of determining the amount properly includible in gross income under section 951(a) by a United States shareholder upon a sale of stock in a lower-tier CFC.

The regulations also contain rules describing basis adjustments resulting from cross-chain sales of foreign corporation stock under section 304(a)(1).

#### E. Basis Adjustments of Consolidated Group Members

In the case where there is sharing of PTI among members of a U.S. consolidated group, the proposed regulations also clarify the interaction of the investment adjustment provisions in the consolidated return regulations with the section 961 basis adjustment provisions. Accordingly, the proposed regulations clarify that a consolidated group member who utilizes PTI of another member shall treat the increase in its PTI account as the receipt of tax exempt income under Prop. Reg.

§1.1502-32(b)(3)(ii)(D), and a member whose PTI is utilized shall treat the reduction in its PTI account as a noncapital nondeductible expense under Prop. Reg. §1.1502-32(b)(3)(iii)(B) for purposes of making the investment adjustments required by §1.1502-32.

#### F. Proposed Effective Date and Transition Rule

These regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date these regulations are published as final regulations in the **Federal Register**, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end. After these regulations become effective, foreign corporations and shareholders who are currently accounting for PTI in a manner other than that which is provided in these regulations may use any reasonable method to conform their current accounting of PTI to the rules provided in these regulations.

#### Request for Comments

##### A. Coordination of Shareholder-level and Corporate-level Accounts

Prop. Reg. §1.959-3(e)(4) requires aggregate categories of PTI to be maintained at the corporate level and to be adjusted in accordance with adjustments made to the individual shareholder-level PTI accounts. No explicit rules are provided for how shareholder-level and corporate-level PTI information is to be shared among the shareholders of a foreign corporation. Comments are requested on whether such information sharing rules are necessary and, if so, how they should operate to ensure conformity between shareholder-level and corporate-level PTI accounting.

##### B. PTI and Consolidated Groups

The application of the PTI sharing rules in the proposed regulations result in corresponding adjustments to the basis of stock in the sharing member corporations (and potentially higher tier members) held by other members of the shareholder's consolidated group. As noted above, the IRS and Treasury Department believe that the

PTI sharing rules result in the corresponding basis adjustments under the current investment adjustment provisions. There is some tension between single and separate entity treatment of a consolidated group regarding the PTI sharing rules, and the IRS and Treasury Department are continuing to study how to balance the policy in favor of minimizing multiple income inclusions with the policy of preserving the location of attributes within a consolidated group. In particular, the IRS and Treasury Department are concerned about the potential basis shifting that may occur as a result of the PTI sharing rules. The IRS and Treasury Department request comments on the proposed rules and whether there are more appropriate rules for determining the basis of: (1) the stock in a member of the consolidated group that transfers PTI to another member of the consolidated group under the proposed regulations; (2) the stock in the member of the consolidated group that receives the transferred PTI under the proposed regulations; and (3) the stock in the higher-tier members of the consolidated group that directly or indirectly own the stock in the members of the consolidated group whose PTI accounts are affected by the sharing rules in the proposed regulations.

The proposed regulations do not limit the application of the PTI sharing rules between members of a consolidated group to PTI earned by a foreign corporation while the member with excess PTI was a member of such group. The IRS and Treasury Department did not adopt such a limitation out of concern that it would be overly complex and concern that such a limitation might not be consistent with the successor in interest rule. However, the IRS and Treasury Department recognize that some may believe that such a limitation might be more consistent with other attribute sharing rules in the consolidated group context. Consequently, the IRS and Treasury Department request comments as to whether a limitation on PTI sharing between members of a consolidated group similar to those of §1.1502-21(c) is appropriate.

The IRS and Treasury Department believe that transactions described in section 304 are generally covered by the PTI sharing rules contained in Prop. Reg. §§1.959-3(h)(1) through (3) that are applicable to typical redemptions. However, a specific rule has also been provided in



Prop. Reg. §1.959-3(h)(4) that makes the PTI sharing rules explicitly applicable to transactions described in section 304(a)(1) that are treated as distributions of property to which section 301 applies. The IRS and Treasury Department request comments regarding whether the PTI sharing rules should also be made explicitly applicable to transactions described in section 304(a)(1) that are treated as sales or exchanges or to transactions described in section 304(a)(2). In addition, comments are requested on whether rules should be provided to address the proper allocation of PTI after a transaction described in section 355.

#### C. PTI and Section 367(b) Transactions.

On November 15, 2000, the IRS and Treasury Department issued proposed regulations in the **Federal Register** (65 FR 69138) (REG-116050-99, 2000-2 C.B. 520) addressing (1) the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in a section 367(b) transaction described in section 381, and (2) the allocation of certain tax attributes when a corporation distributes stock in another corporation in a section 367(b) transaction (a foreign divisive transaction). In the preamble to those proposed regulations, the IRS and Treasury Department indicated that further guidance under section 959 would be required prior to addressing PTI issues that arise under section 367(b). At that time the IRS and Treasury Department requested comments with respect to proposed §1.367(b) regarding whether PTI should be transferable and retain its character as PTI for section 959 purposes, as well as the various implications that result from that determination. Additionally, in the 2000 proposed regulations, the IRS and Treasury Department requested comments with respect to §1.367(b)-8 of the proposed regulations regarding the proper adjustment of the PTI of a CFC following a foreign divisive transaction.

On August 8, 2006, the IRS and Treasury Department issued final regulations under §§1.367(b)-3 and -7 with respect to the carryover of non-PTI amounts, among other things, while reserving final regulations under §1.367(b)-8 with respect to the

allocation of tax attributes in foreign divisive transactions.

The IRS and Treasury Department invite comments regarding the proper extension of the principles in these proposed regulations (including shareholder-level accounting of PTI and the PTI sharing rules) to §§1.367(b)-3 and -7, as well as Prop. Reg. §1.367(b)-8.

#### D. Foreign Currency Gain or Loss and Foreign Tax Credits With Respect to PTI Distributions

Under section 986(c) of the Code, foreign currency gain or loss with respect to distributions of PTI that is attributable to movements in exchange rates between the date(s) of the income inclusion that created the PTI and the distribution of such PTI shall be recognized and treated as ordinary income or loss from the same source as the associated income inclusion. The IRS and Treasury Department invite comments regarding additional guidance that may be needed under section 986(c) in light of the proposed regulations under section 959. The IRS and Treasury Department also invite comments regarding additional guidance that is needed to ensure that section 960(a)(3) provides appropriate foreign tax credit rules with respect to taxes imposed on PTI that is distributed through tiers of foreign corporations.

#### E. Section 962

The IRS and Treasury Department have not determined how the proposed accounting rules and basis rules should apply to a United States individual shareholder who has elected to be taxed as a corporation under section 962. Therefore, those rules are reserved for future study. The IRS and Treasury Department, however, invite comments about how the PTI rules and basis rules should apply for purposes of section 962.

#### F. Section 961(c) Basis Adjustments

Section 961(c) is only applicable for purposes of determining the amount included under section 951 in gross income of a United States shareholder. Consequently, the IRS and Treasury Department have so limited the application of Prop. Reg. §1.961-3. In the event of a sale of

a lower-tier CFC by an upper-tier CFC for which the rules of section 961(c) are implicated in determining the gain on the sale, the basis created in the lower-tier CFC stock for purposes of applying section 951 would not apply, for example, to determine the earnings and profits of the upper-tier CFC. However, the IRS and Treasury Department are concerned about the potential double taxation that may result in the event of the later distribution of these earnings and profits to a United States person.

#### G. Transition Rule

These regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date these regulations are published as final regulations in the **Federal Register**, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end. After these regulations become effective, foreign corporations and shareholders who are currently accounting for PTI in a manner other than that which is provided in these regulations may use any reasonable method to conform their current accounting of PTI to the rules provided in these regulations. Comments are requested on whether more detailed transition rules should be provided, and, if so, how such transition rules should operate to conform existing methods of PTI accounting with the method of PTI accounting required by these regulations.

#### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It 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 proposed regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. Ch. 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Comments and Requests for Public Hearing

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

## Drafting Information

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

\* \* \* \* \*

## Proposed Amendments to the Regulations

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

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing all entries for §1.1502-12 and §1.1502-32 and by adding entries in numerical order to read, in part, as follows:

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

Section 1.959-1 also issued under 26 U.S.C. 304(b)(6), 959 and 1502.

Section 1.959-2 also issued under 26 U.S.C. 304(b)(6) and 959.

Section 1.959-3 also issued under 26 U.S.C. 304(b)(6), 959 and 1502.

Section 1.959-4 also issued under 26 U.S.C. 304(b)(6) and 959. \* \* \*

Section 1.961-1 also issued under 26 U.S.C. 961.

Section 1.961-2 also issued under 26 U.S.C. 961.

Section 1.961-3 also issued under 26 U.S.C. 961.

Section 1.961-4 also issued under 26 U.S.C. 304(b)(6) and 961. \* \* \*

Section 1.1502-12 also issued under 26 U.S.C. 959, 961 and 1502. \* \* \*

Section 1.1502-32 also issued under 26 U.S.C. 301, 959, 961, 1502 and 1503. \* \* \*

Par. 2. Section 1.959-1 is revised to read as follows:

*§1.959-1 Exclusion from gross income of United States persons of previously taxed earnings and profits.*

(a) *In general.* Section 959(a) provides an exclusion whereby the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in a United States shareholder's gross income under section 951(a) are not taxed again when distributed (directly or indirectly through a chain of ownership described in section 958(a)) from such foreign corporation to such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary may by regulations prescribe). Section 959(a) also excludes from gross income of a United States shareholder earnings and profits attributable to amounts which are, or have been, included in the gross income of such shareholder under section 951(a) which would, but for section 959(a)(2), be again included in the gross income of such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary may by regulations prescribe) under section 951(a)(1)(B). Section 959(b) provides that for purposes of section 951(a), the earnings and profits of a CFC attributable to amounts that are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be included in the gross income of a CFC in such chain for purposes of the application of section 951(a) to such CFC with respect to such United States shareholder

(or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary may by regulations prescribe). Section 959(c) provides rules for the allocation of distributions to the various categories of previously taxed earnings and profits of a foreign corporation and the foreign corporation's non-previously taxed earnings and profits. Section 959(d) provides that, except as provided in section 960(a)(3), any distribution excluded from gross income under section 959(a) shall be treated as a distribution which is not a dividend; except that any such distribution shall immediately reduce earnings and profits. Section 959(e) provides that, for purposes of sections 959 and 960(b), any amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 shall be treated as an amount included in the gross income of such person (or, in any case to which section 1248(e) applies, of the domestic corporation referred to in section 1248(e)(2)) under section 951(a)(1)(A). Section 959(f)(1) provides rules for the allocation of amounts which would, but for section 959(a)(2), be included in gross income under section 951(a)(1)(B) to certain previously taxed earnings and profits of a foreign corporation and non-previously taxed earnings and profits. Section 959(f)(2) provides an ordering rule pursuant to which the rules of section 959 are applied first to actual distributions and then to amounts which would, but for section 959, be included in gross income under section 951(a)(1)(B). Paragraph (b) of this section provides a list of definitions. Paragraph (c) of this section provides rules for the exclusion from gross income under section 959(a)(1) of distributions of earnings and profits by a foreign corporation and the exclusion from gross income under section 959(a)(2) of amounts which would, but for section 959, be included in gross income under section 951(a)(1)(B). Paragraph (d) of this section provides for the establishment and acquisition of previously taxed earnings and profits accounts by shareholders of foreign corporations. Section 1.959-2 provides rules for the exclusion from gross income of a CFC of distributions of previously

taxed earnings and profits from another CFC in a chain of ownership described in section 958(a). Section 1.959-3 provides rules for the allocation of distributions and section 956 amounts to the earnings and profits of a CFC and for the maintenance and adjustment of previously taxed earnings and profits accounts by shareholders of foreign corporations. Section 1.959-4 provides for the treatment of actual distributions that are excluded from gross income under section 959(a).

(b) *Definitions.* For purposes of this section through §1.959-4 and §1.961-1 through §1.961-4, the terms listed in this paragraph are defined as follows:

(1) *Previously taxed earnings and profits* means the earnings and profits of a foreign corporation, computed in accordance with sections 964 and 986(b) and the regulations thereunder, attributable to section 951(a) inclusions.

(2) *Previously taxed earnings and profits account* means an account reflecting the previously taxed earnings and profits of a foreign corporation (if any).

(3) *Dollar basis* means the United States dollar amounts included in a United States shareholder's income with respect to the previously taxed earnings and profits included in a shareholder's previously taxed earnings and profits account.

(4) *Covered shareholder* means a person who is one of the following—

(i) A United States person who owns stock (within the meaning of section 958(a)) in a foreign corporation and who has had a section 951(a) inclusion with respect to its stock in such corporation;

(ii) A successor in interest, as defined in paragraph (b)(5) of this section; or

(iii) A corporation that is not described in paragraphs (b)(4)(i) or (ii) of this section and that owns stock (within the meaning of section 958(a)) in a foreign corporation in which another corporation is a covered shareholder described in paragraph (b)(4)(i) or (ii) of this section, if both the first mentioned corporation and the covered shareholder are members of the same consolidated group.

(5) *Successor in interest* means a United States person who acquires, from any person, ownership (within the meaning of section 958(a)) of stock in a foreign corporation, for which there is a previously taxed earnings and profits account and who establishes to the satisfaction of the Director

of Field Operations the right to the exclusion from gross income provided by section 959(a) and this section. To establish the right to the exclusion, the shareholder must attach to its return for the taxable year a statement that provides that it is excluding amounts from gross income because it is a successor in interest succeeding to one or more previously taxed earnings and profits accounts with respect to shares it owns in a foreign corporation. Included in the statement shall be the name of the foreign corporation. In addition, that shareholder must be prepared to provide the following information within 30 days upon request by the Director of Field Operations—

(i) The name, address, and taxable year of the foreign corporation and of all the other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(ii) The name, address, and taxpayer identification number, if any, of the person from whom the stock interest was acquired;

(iii) A description of the stock interest acquired and its relation, if any, to a chain of ownership described in section 958(a);

(iv) The amount for which an exclusion under section 959(a) and paragraph (c) of this section is claimed; and

(v) Evidence showing that the earnings and profits for which an exclusion is claimed are previously taxed earnings and profits, that such amounts were not previously excluded from the gross income of a United States person, and the identity of the United States shareholder who originally included such amounts in gross income under section 951(a). The acquiring person shall also furnish to the Director of Field Operations such other information as may be required by the Director of Field Operations in support of the exclusion.

(6) *Block of stock* shall have the meaning provided in §1.1248-2(b) with the additional requirement that the previously taxed earnings and profits attributable to each share of stock in such block must be the same.

(7) *Consolidated group* shall have the meaning provided in §1.1502-1(h).

(8) *Member* shall have the meaning provided in §1.1502-1(b).

(9) *Section 951(a) inclusion* means a section 951(a)(1)(A) inclusion or an

amount included in the gross income of a United States shareholder under section 951(a)(1)(B).

(10) *Section 951(a)(1)(A) inclusion* means—

(i) An amount included in a United States shareholder's gross income under section 951(a)(1)(A);

(ii) An amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 (or, in any case to which section 1248(e) applies, an amount included in the gross income of the domestic corporation referred to in section 1248(e)(2)); or

(iii) An amount described in section 1293(c).

(11) *Section 956 amount* means an amount determined under section 956 for a United States shareholder with respect to a single share or, if a shareholder maintains a previously taxed earnings and profits account with respect to a block of stock, a block of such shareholder's stock in the CFC.

(12) *Section 959(c)(1) earnings and profits* means the previously taxed earnings and profits of a foreign corporation attributable to amounts that have been included in the gross income of a United States shareholder under section 951(a)(1)(B) (or which would have been included except for section 959(a)(2) and §1.959-2) and amounts that have been included in gross income under section 951(a)(1)(C) as it existed prior to its repeal (or which would have been included except for section 959(a)(3) as it existed prior to its repeal).

(13) *Section 959(c)(2) earnings and profits* means the previously taxed earnings and profits of a foreign corporation attributable to section 951(a)(1)(A) inclusions.

(14) *Non-previously taxed earnings and profits* means the earnings and profits of a foreign corporation other than the corporation's previously taxed earnings and profits.

(15) *CFC* means a controlled foreign corporation within the meaning of either section 953(c)(1)(B) or section 957.

(16) *United States shareholder* means a United States person who qualifies as a United States shareholder under either section 951(b) or section 953(c)(1)(A).

(c) *Amount excluded from gross income*—(1) *Distributions.* In the case of

a distribution of earnings and profits to a covered shareholder with respect to stock in a foreign corporation, an amount shall be excluded from such shareholder's gross income equal to the total amount by which such shareholder's previously taxed earnings and profits account with respect to such stock is decreased under §1.959-3 because of the distribution.

(2) *Section 956 amounts.* In a case where a covered shareholder has a section 956 amount for a CFC's taxable year, an amount shall be excluded from such shareholder's gross income equal to the amount of section 959(c)(2) earnings and profits in any shareholder's previously taxed earnings and profits account that are reclassified as section 959(c)(1) earnings and profits under §1.959-3 because of that section 956 amount.

(d) *Shareholder accounts—(1) In general.* Any person who is subject to §1.959-3 shall maintain a previously taxed earnings and profits account with respect to each share of stock it owns (within the meaning of section 958(a)) in a foreign corporation. Although the account is share specific, the account may be maintained with respect to each block of the stock in the foreign corporation. Such account shall be maintained in accordance with §1.959-3.

(2) *Acquisition of account—(i) In general.* If any person acquires, from any other person, ownership of shares of stock in a foreign corporation (within the meaning of section 958(a)) the prior shareholder's previously taxed earnings and profits account with respect to such stock becomes the previously taxed earnings and profits account of the acquirer.

(ii) *Acquisition of account by a person other than a successor in interest.* If such acquirer is not a successor in interest (a foreign person for example), the previously taxed earnings and profits account with respect to the stock acquired shall remain unchanged for the period that the stock is owned by such acquirer. See also §1.959-3(e), providing account adjustment rules that apply only for acquired PTI accounts if the acquirer is a successors in interest.

(3) *Examples.* The application of this paragraph (d) is illustrated by the following examples:

*Example 1. Shareholder's previously taxed earnings and profits account.* (i) *Facts.* DP, a United

States shareholder owns all of the 100 shares of the only class of stock in FC, a CFC. The 100 shares are a block of stock. DP and FC use the calendar year as their taxable year and FC uses the U.S. dollar as its functional currency. In year 1, FC earns \$100x of subpart F income and \$100x of non-subpart F income. DP includes \$100x in gross income under section 951(a).

(ii) *Analysis.* As a result of DP's inclusion of \$100x of gross income under section 951(a), DP has a previously taxed earnings and profits account with respect to each of its 100 shares equal to \$1x or should DP choose to maintain its previously taxed earnings and profits account on a block basis, an account of \$100x with respect to its entire interest in FC.

*Example 2. Acquisition of previously taxed earnings and profits account.* (i) *Facts.* Assume the same facts as *Example 1*, but that in year 2, a nonresident alien, FP, contributes property to FC to acquire 1000 newly issued shares of FC of the same class held by DP. In year 10, DP sells all of its FC shares to FP. In year 15, FP sells all of its shares in FC to USP, a United States person. Any income earned by FC after year 1 is non-subpart F income. The only distributions by FC during this period are a \$100x pre-sale distribution to FP in year 15 and another \$100x distribution in year 16 to USP.

(ii) *Analysis.* In year 2, DP retains its previously taxed earnings and profits account of \$100x as a result of its section 951(a) inclusion in year 1 regardless of the fact that FC is no longer a CFC and DP no longer holds a sufficient interest in FC to be a United States shareholder with respect to FC. In year 10, pursuant to paragraph (d)(2)(i) of this section, FP acquires a \$100x previously taxed earnings and profits account with respect to DP's block of stock in FC that FP acquired. In year 15, FP receives a distribution of \$100x of earnings and profits from FC, but FP may not exclude any of this distribution from gross income because FP is a nonresident alien. Consequently, pursuant to paragraph (d)(2)(ii) of this section, even though it acquired a previously taxed earnings and profits account from DP of \$100x the account remains unchanged during FP's ownership of the FC stock. However, if USP can make the showing required in paragraph (b)(5) of this section, USP may exclude the \$100x distribution in year 16 under section 959(a)(1) and paragraph (c) of this section to the extent that the distribution results in a decrease of the \$100x previously taxed earnings and profits account that USP acquired from FP pursuant to the account adjustment rules of §1.959-3.

Par. 3. Section 1.959-2 is revised to read as follows:

*§1.959-2 Exclusion from gross income of CFCs of previously taxed earnings and profits.*

(a) *Exclusion from gross income—(1) In general.* The earnings and profits of a CFC (lower-tier CFC) attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be also

included in the gross income of the CFC receiving the distribution (upper-tier CFC) in such chain for purposes of the application of section 951(a) to such upper-tier CFC with respect to such United States shareholder. The amount of the exclusion provided under this paragraph is the entire amount distributed by the lower-tier CFC to the upper-tier CFC that gave rise (in whole or in part) to an adjustment of the United States shareholder's previously taxed earnings and profits accounts with respect to the stock it owns (within the meaning of section 958(a)) in the lower- and upper-tier CFC under §1.959-3(e)(3). This amount shall not exceed the earnings and profits of the lower-tier CFC attributable to amounts described in section 951(a)(1) (without regard to *pro rata* share). The exclusion from the income of such upper-tier CFC also applies with respect to any other United States shareholder who is a successor in interest.

(2) *Examples.* The application of this paragraph (a) is illustrated by the following examples:

*Example 1. Distribution attributable to subpart F income of lower-tier CFC.* (i) *Facts.* FC, a CFC, is 70% owned by DP, a United States person, and 30% owned by FP, a nonresident alien. FC owns all the stock in FS, a CFC. DP, FP, FC and FS all use the calendar year as their taxable year and FC and FS use the U.S. dollar as their functional currency. In year 1, FS earns \$100x of passive income described in section 954(c) and \$50x of non-subpart F income. On the last day of year 1, FS distributes \$100x to FC that would qualify as subpart F income of FC. On the last day of year 1, FC distributes \$70x to DP and \$30x to FP.

(ii) *Analysis.* DP is required to include \$70x in its gross income under section 951(a) as a result of FS's earning \$100x of subpart F income for the year. Consequently, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its indirect ownership of stock in FS is increased to \$70x. Under §1.959-3(e)(3), as a result of the \$100x distribution paid by FS to FC, DP's previously taxed earnings and profits account is reduced by its *pro rata* share of the distribution (\$70x). In addition, FS's non-previously taxed earnings and profits are reduced by the remaining \$30x. Under paragraph (a) of this section, the amount of the exclusion under paragraph (a) is equal to the amount distributed, not to exceed the amount of earnings and profits that gave rise to the previously taxed income that is being distributed. Consequently, the entire \$100x distribution (as opposed to only \$70x) is excluded from FC's gross income for purposes of determining whether DP has an inclusion under section 951(a) as a result of FC's receiving the distribution from FS. The receipt of the distribution from FS increases FC's earnings and profits by \$100x (\$70x of which is previously taxed earnings and profits and \$30x of which is non-previously taxed earnings and profits).

*Example 2. Transferee shareholder.* (i) *Facts.* The facts are the same as in *Example 1* except that neither FS nor FC makes any distributions in year 1. In year 2, FP sells its stock in FC to DT, a United States person. On the last day of year 2, FS distributes \$100x to FC that would qualify as subpart F income of FC. FS has no earnings and profits for year 2, and FC has no earnings and profits for year 2 other than the distribution from FS.

(ii) *Analysis.* With respect to DP, the analysis is the same as that in *Example 1*. However, for purposes of DT's determination of the amount includible in its gross income under section 951(a) with respect to FC for year 2, none of the \$100x distribution is excluded from FC's gross income for purposes of applying section 951(a) with respect to DT's interest in FC because none of earnings and profits distributed by FS to FC are attributable to amounts which are, or have been, included in the gross income of DT or the person to whom DT is a successor in interest (FP). Consequently, DT must include \$30x in gross income under section 951(a) for year 2 as its *pro rata* share of FC's subpart F income of \$100x ( $\$100x \times 30\%$ ). Thereafter, DT has a previously taxed earnings and profits account consisting of \$30x with respect to its stock in FC and FC has \$100x of previously taxed earnings and profits.

*Example 3. Mixed distribution.* (i) *Facts.* The facts are the same as in *Example 1*, except that on the last day of year 1, FS distributes \$150x to FC that would qualify as subpart F income of FC, which in turn distributes \$105x to DP and \$45x to FP.

(ii) *Analysis.* Under the analysis in *Example 1* and pursuant to paragraph (a) of this section, \$100x of the distribution from FS to FC is excluded from FC's gross income for purposes of determining DP's inclusion under section 951(a) with respect to FC's receipt of the distribution from FS. However, DP's *pro rata* share of the remaining \$50x, or \$35x ( $\$50x \times 70\%$ ), is included in DP's gross income under section 951(a). Consequently, the previously taxed earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FC is increased from \$70x to \$105x pursuant to §1.959-3(e)(2)(i). That account is then reduced to \$0 as a result of the distribution of \$105x to DP pursuant to §1.959-3(e)(2)(ii) and DP excludes the distribution of \$105x from FC from its gross income for year 1 under section 959(a)(1) and §1.959-1(c).

(b) *Section 304(a)(1) transactions—(1) Deemed redemption treated as a distribution.* In the case of a stock acquisition under section 304(a)(1) treated as a distribution to which section 301 applies, the selling CFC shall be deemed for purposes of section 959(b) and paragraph (a) of this section to receive such distributions through a chain of ownership described under section 958(a).

(2) *Example.* The application of this paragraph (c) is illustrated by the following example:

*Example. Cross-chain acquisition of CFC stock by a CFC from another CFC.* (i) *Facts.* DP, a domestic corporation, owns all of the stock in two foreign corporations, FX and FY. FX owns all of the stock in foreign corporation FZ. DP, FX, FY, and FZ all use

the calendar year as their taxable year and the U.S. dollar as their functional currency. During year 1, FY purchases all of the stock in FZ from FX for \$80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of FZ's stock, FY has section 959(c)(2) earnings and profits of \$20x and non-previously taxed earnings and profits of \$10x, and FZ has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$0.

(ii) *Analysis.* Under section 304(a)(1), FX is deemed to have transferred the FZ stock to FY in exchange for FY stock in a transaction to which section 351 applies, and FY is treated as having redeemed, for \$80x, the FY stock deemed issued to FX. The payment of \$80x is treated as a distribution to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend (and the source) is made as if the distribution were made, first, by FY to the extent of its earnings and profits, \$30x, and then by FX to the extent of its earnings and profits, \$50x. Under paragraph (c)(1) of this section, FX is deemed to receive the distributions from FY and FZ through a chain of ownership described in section 958(a). Under paragraph (a) of this section, the amount of FY's previously taxed earnings and profits, \$20x, and the amount of FZ's previously taxed earnings and profits, \$50x, distributed to FX are excluded from the gross income of FX. Accordingly, only \$10x is included in FX's gross income.

Par. 4. Section 1.959-3 is revised to read as follows:

*§1.959-3 Maintenance and adjustment of previously taxed earnings and profits accounts.*

(a) *In general.* This section provides rules for the maintenance and adjustment of previously taxed earnings and profits accounts by shareholders and with respect to foreign corporations. Paragraph (b) of this section provides general rules governing the accounting of previously taxed earnings and profits at the shareholder level and corporate level. Paragraph (c) of this section provides rules regarding the treatment of foreign taxes when previously taxed earnings and profits are distributed by a foreign corporation through a chain of ownership described in section 958(a). Paragraph (d) of this section provides rules regarding the allocation of other expenses to previously taxed earnings and profits. Paragraph (e)(1) of this section addresses the adjustment of shareholder-level previously taxed earnings and profits accounts as a result of certain transactions. Paragraph (e)(2) of this section provides rules establishing the order in which adjustments are to be made to a covered shareholder's previously taxed earnings and profits account. Paragraph (e)(3) of this

section provides rules regarding distributions of previously taxed earnings and profits in a chain of ownership described in section 958(a). Paragraph (e)(4) of this section provides for the maintenance and adjustment of aggregate categories of previously taxed and non-previously taxed earnings and profits at the corporate level with adjustments to individual shareholder-level accounts. Paragraph (e)(5) of this section provides rules for the effect of a foreign corporation's deficit in earnings and profits on previously taxed earnings and profits. Paragraph (f) of this section provides rules regarding the treatment of previously taxed earnings and profits when a shareholder has multiple previously taxed earnings and profits accounts. Paragraph (g) of this section provides rules regarding the treatment of previously taxed earnings and profits when more than one shareholder in a foreign corporation is a member of the same consolidated group. Paragraph (h) of this section provides rules governing the adjustment of previously taxed earnings and profits accounts in the case of a redemption.

(b) *Corporate-level and shareholder-level accounting of previously taxed earnings and profits—(1) Shareholder-level accounting.* A shareholder's previously taxed earnings and profits account with respect to its stock in a foreign corporation shall identify the amount of section 959(c)(1) earnings and profits and the amount of section 959(c)(2) earnings and profits attributable to such stock for each taxable year of the foreign corporation and shall be maintained in the functional currency of such foreign corporation. A shareholder account must also reflect the annual dollar basis of each category of previously taxed earnings and profits in the account. See §1.959-3(e) of this section for rules regarding the adjustment of shareholder previously taxed earnings and profits accounts.

(2) *Corporate-level accounting.* Separate aggregate categories of section 959(c)(1), section 959(c)(2) and non-previously taxed earnings and profits (earnings and profits described in section 959(c)(3)) shall be maintained with respect to a foreign corporation. These categories of earnings and profits of the foreign corporation shall be maintained in the functional currency of the foreign corporation. For purposes of this section,

distributions are allocated to a foreign corporation's earnings and profits under section 316(a) by applying first section 316(a)(2) and then section 316(a)(1) to each of these three categories of earnings and profits. Section 956 amounts shall be treated as attributable first to section 959(c)(2) earnings and profits and then to non-previously taxed earnings and profits. These allocations are made in conjunction with the rules for making corporate-level adjustments to previously taxed earnings and profits under §1.959-3(e)(4).

(3) *Classification of earnings and profits*—(i) *In general.* For purposes of this section, earnings and profits are classified as to year and category of earnings and profits in the taxable year of the foreign corporation in which such amounts are included in the gross income of a United States shareholder under section 951(a) and are reclassified as to category of earnings and profits in the taxable year of the foreign corporation in which such amounts would be so included in the gross income of a United States shareholder under section 951(a) but for the provisions of section 959(a)(2) and §1.959-1(c)(2). Such classifications do not change by reason of a subsequent distribution of such amounts to an upper-tier corporation in a chain of ownership described in section 958(a). This paragraph shall apply to distributions by one foreign corporation to another foreign corporation and by a foreign corporation to a United States person.

(ii) *Dollar basis pooling election.* For purposes of computing foreign currency gain or loss under section 986(c) and adjustments to stock basis under section 961(b) and (c) with respect to distributions of previously taxed earnings and profits of any foreign corporation, in lieu of maintaining annual dollar basis accounts with respect to previously taxed earnings and profits described in paragraph (b)(1) of this section, a taxpayer may maintain an aggregate dollar basis pool that reflects the dollar basis of all of the corporation's previously taxed earnings and profits described in sections 959(c)(1) and 959(c)(2) and treat a *pro rata* portion of the dollar basis pool as attributable to distributions of such previously taxed earnings and profits. A taxpayer makes this election by using a dollar basis pool to compute foreign currency gain or loss under section 986(c) with respect to distributions

of previously taxed earnings and profits of the foreign corporation, or to compute gain or loss with respect to its stock in the foreign corporation, whichever occurs first. Any subsequent change in the taxpayer's method of assigning dollar basis may be made only with the consent of the Commissioner.

(4) *Examples.* The application of this paragraph (b) is illustrated by the following examples:

*Example 1. Distribution.* (i) *Facts.* DP, a United States shareholder, owns 100% of the only class of stock in FC, a CFC, which, in turn, owns 100% of the only class of stock in FS, a CFC. DP, FC and FS all use the calendar year as their taxable year. FC and FS both use the u as their functional currency. During year 1, FC earns 100u of non-subpart F income and invests 100u in United States property. DP must include 100u in its gross income for year 1 under section 951(a)(1)(B) with respect to FC. For year 2, FS has no subpart F income or investment of earnings in United States property but FS has 100u of non-previously taxed earnings and profits which it distributes to FC. The distribution of 100u to FC is subpart F income of FC and DP must include the 100u in its gross income for year 2 under section 951(a)(1)(A). Also in year 2, FC has non-subpart F income of 100u. The exchange rates at all times in year 1 and year 2, respectively, are  $1u = \$1$  and  $1u = \$1.20$ .

(ii) *Analysis.* With respect to FC, the earnings and profits are classified as follows: 100u of section 959(c)(1) earnings and profits from year 1, 100u of section 959(c)(2) earnings and profits from year 2, and 100u of non-previously taxed earnings and profits from year 2. The dollar basis with respect to the section 959(c)(1) earnings and profits is \$100 and the dollar basis with respect to the section 959(c)(2) earnings and profits is \$120.

*Example 2. Subsequent distribution in a later year.* (i) *Facts.* Assume the same facts as in *Example 1*, except that during year 3 neither FC nor FS has any earnings and profits or deficit in earnings and profits or section 956 amount, but FC distributes 100u to DP on December 31, year 3, at which time the spot exchange rate is  $1u = \$1.30$ .

(ii) *Analysis.* For purposes of section 959 and 961, the 100u distribution of FC shall be considered attributable to FC's section 959(c)(1) earnings and profits for year 1. The section 959(c)(1) earnings and profits are reduced by 100u and the dollar basis of the account is reduced by \$100. Since the spot rate at the time of the 100u distribution to DP is  $1u = \$1.30$ , DP recognizes foreign currency gain of  $\$30 ((100 \times 1.3) - (100 \times 1))$ .

*Example 3. Dollar basis pooling election.* (i) *Facts.* Assume the same facts as in *Example 2*, except that DP elected to maintain the dollar basis of its previously taxed earnings and profits account on a pooled basis for purposes of section 986(c) and section 961 as provided in paragraph (b)(3)(ii) of this section.

(ii) *Analysis.* The section 959(c)(1) earnings and profits are reduced by 100u, but the dollar basis of the account is reduced by \$110  $((100u/200u) \times \$220)$ . In addition, DP recognizes foreign currency gain under section 986(c) of  $\$20 (\$130 - ((100u/200u) \times \$220))$ .

(c) *Treatment of certain foreign taxes.*

(1) For purposes of this section, when previously taxed earnings and profits are distributed by a foreign corporation to another foreign corporation through a chain of ownership described in section 958(a) such earnings and profits shall be reduced by the functional currency amount of any income, war profits, or excess profits taxes imposed by any foreign country or a possession of the United States on or with respect to such earnings and profits. Any such taxes shall not be included in the distributee foreign corporation's pools of post-1986 foreign income taxes maintained for purposes of sections 902 and 960(a)(1). Such taxes shall be maintained in a separate account and allowed as a credit as provided under section 960(a)(3) when the associated previously taxed earnings and profits are distributed. The taxpayer's dollar basis in the previously taxed earnings and profits account shall be reduced by the dollar amount of such taxes, translated in accordance with section 986(a).

(2) *Example.* The application of this paragraph (c) is illustrated by the following example:

*Example. Imposition of foreign taxes on a CFC.*

(i) *Facts.* DP, a United States shareholder, owns 100% of the only class of stock in foreign corporation FC, a CFC, which, in turn, owns 100% of the only class of stock in FS, a CFC. DP, FC, and FS all use the calendar year as their taxable year. FC and FS both use the u as their functional currency. During year 1, FS earns 90u of subpart F income, after incurring 10u of foreign income tax allocable to such income under §1.954-1(c), has earnings and profits in excess of 90u, and makes no distributions. DP must include 90u, translated at the average exchange rate for the year of  $1u = \$1$  as provided in section 989(b)(3), in its gross income for year 1 under section 951(a)(1)(A)(i). As of the end of year 1, FS has section 959(c)(2) earnings and profits of 90u. During year 2, FS has neither earnings and profits nor a deficit in earnings and profits but distributes 90u to FC, and, by reason of section 959(b) and §1.959-2, such amount is not includable in the gross income of DP for year 2 under section 951(a) with respect to FC. FC incurs a withholding tax of 9u on the 90u distribution from FS (10% of 90u) and an additional foreign income tax of 11u by reason of the inclusion of the distribution in its taxable income for foreign tax purposes in year 2. The average exchange rate for year 2 is  $1u = \$2$ .

(ii) *Analysis.* At the end of year 2, FS has section 959(c)(2) earnings and profits of 0 (90u - 90u); and FC has section 959(c)(2) earnings and profits of 70u (90u - 9u - 11u). DP's dollar basis in the 70u section 959(c)(2) earnings and profits account with respect to FC is \$50 (\$90 inclusion - \$18 withholding tax - \$22 income tax). The \$40 of foreign taxes imposed on

FC with respect to the previously taxed earnings and profits are not included in FC's post-1986 foreign income taxes pool. A foreign tax credit with respect to the \$40 of foreign tax attributable to the 70u of previously taxed earnings and profits will be allowed under section 960(a)(3) upon distribution of such previously taxed earnings and profits.

(d) *Treatment of other expenses.* Except as provided in paragraph (c) of this section, no expense paid or accrued by a foreign corporation shall be allocated or apportioned to the previously taxed earnings and profits of such corporation.

(e) *Adjustments to previously taxed earnings and profits account—(1) In general.* A covered shareholder's previously taxed earnings and profits account (including the dollar basis in such account) is adjusted in the manner provided in paragraphs (e)(2), (f) and (g) of this section, except as otherwise provided in paragraph (e)(3) of this section. For adjustments to a previously taxed earnings and profits account in the case of redemptions, see paragraph (h) of this section.

(2) *Order and amount of adjustments.* As of the close of a foreign corporation's taxable year, and for the taxable year of the covered shareholder in which or with which such taxable year of the foreign corporation ends, the covered shareholder shall make any of the following adjustments that are applicable for that year to the previously taxed earnings and profits account for the stock owned for any portion of such year (within the meaning of section 958(a)) in the foreign corporation in the following order—

(i) *Step 1. Section 951(a)(1)(A) inclusion.* Increase the amount of section 959(c)(2) earnings and profits and the associated dollar basis in the account by the amount of the section 951(a)(1)(A) inclusion with respect to such stock;

(ii) *Step 2. Distributions on such stock.* (A) Decrease the amount of the section 959(c)(1) earnings and profits in the account (but not below zero), and then the amount of section 959(c)(2) earnings and profits in the account (but not below zero) by the amount of earnings and profits distributed to the covered shareholder during the year with respect to such stock, decrease the dollar basis in the account by the dollar amount attributable to the distributed earnings and profits; and

(B) Increase the amount of the earnings and profits and associated dollar basis, in the account first to the extent pro-

vided under paragraph (f)(1) of this section and then to the extent provided under paragraph (g)(1) of this section and then reduce the account to zero;

(iii) *Step 3. Reallocation from other accounts with respect to redemptions.* Increase the amount of the earnings and profits and associated dollar basis in the account to the extent provided under paragraph (h)(3)(ii) of this section.

(iv) *Step 4. Section 956 amount.* Reclassify the section 959(c)(2) earnings and profits and associated dollar basis in such shareholder's previously taxed earnings and profits account with respect to such stock as section 959(c)(1) earnings and profits in an amount equal to the lesser of—

(A) The covered shareholder's section 956 amount for the taxable year with respect to such stock; or

(B) The amount of the section 959(c)(2) earnings and profits attributable to such stock.

(v) *Step 5. Reallocation to other accounts with respect to distributions.* Decrease the amount of section 959(c)(1) earnings and profits and associated dollar basis in the account, and thereafter the amount of section 959(c)(2) earnings and profits and associated dollar basis in the account to the extent provided under paragraph (f)(1) of this section and then under paragraph (g)(1) of this section;

(vi) *Step 6. Reclassification with respect to section 956 amounts.* Reclassify the section 959(c)(2) earnings and profits and the associated dollar basis attributable to such stock as section 959(c)(1) earnings and profits to the extent provided under paragraph (f)(2) of this section and then to the extent provided in paragraph (g)(2) of this section.

(vii) *Step 7. Further adjustment for section 956 amounts.* Increase the amount of section 959(c)(1) earnings and profits and the associated dollar basis in the account by any amount included in the covered shareholder's gross income for the year under section 951(a)(1)(B) with respect to such stock.

(3) *Intercorporate distributions.* If a foreign corporation receives a distribution of earnings and profits from another foreign corporation that is in a chain of ownership described in section 958(a), a covered shareholder's previously taxed earnings and profits accounts with respect

to the stock in each foreign corporation in such chain shall be adjusted at the end of the respective corporation's taxable year, and for the taxable year of the covered shareholder in which or with which such taxable year of the foreign corporation ends, as follows:

(i) The covered shareholder's previously taxed earnings and profits account with respect to stock in the distributor shall be decreased (but not below zero), at the same time that the covered shareholder would make adjustments under paragraph (e)(2)(ii) of this section, by the amount of the distribution and the associated dollar basis. Such decrease to the covered shareholder's previously taxed earnings and profits account shall be made first to the section 959(c)(1) earnings and profits and thereafter to the section 959(c)(2) earnings and profits in such account.

(ii) Except as provided in paragraph (c) of this section, the section 959(c)(1) earnings and profits and section 959(c)(2) earnings and profits in the covered shareholder's previously taxed earnings and profits account with respect to the stock in the distributee shall be increased, at the same time that the covered shareholder would make adjustments under paragraph (e)(2)(i) of this section, by an amount equal to the decrease under paragraph (e)(3)(i) of this section and to the extent the distribution is out of non-previously taxed earnings and profits of the distributor, to the extent provided under paragraph (e)(2) of this section. If the receiving corporation uses a non-dollar functional currency that differs from the functional currency used by the distributing corporation, then—

(A) The amount of increase shall be the spot value of the distribution in the receiving corporation's functional currency at the time of the distribution; and

(B) The dollar basis of the amount distributed shall be carried over from the distributing corporation to the receiving corporation.

(4) *Effect on foreign corporation's earnings and profits.* Adjustments to a shareholder's previously taxed earnings and profits account in accordance with this section shall result in corresponding adjustments to the appropriate aggregate category or categories of earnings and profits of the foreign corporation. If an adjustment to a foreign corporation's

earnings and profits is required (other than as a result of the previous sentence) the adjustment shall be made only to the non-previously taxed earnings and profits of the corporation except to the extent provided in paragraph (h)(2)(i) of this section. Moreover, if a distribution to a taxpayer exceeds such taxpayer's previously taxed earnings and profits account with respect to stock it owns (within the meaning of section 958(a)) in the foreign corporation making the distribution, the distribution may only be treated as a dividend under section 316 by applying section 316(a)(1) and (2) to the non-previously taxed earnings and profits of the foreign corporation.

(5) *Deficits in earnings and profits.* If a foreign corporation has a deficit in earnings and profits, as determined under section 964(a) and §1.964-1, for any taxable year, a covered shareholder's previously taxed earnings and profits account with respect to its stock in such foreign corporation shall not be adjusted to take into account the deficit and the deficit shall be applied only to the non-previously taxed earnings and profits of the foreign corporation.

(6) *Examples.* The application of this paragraph (e) is illustrated by the following examples:

*Example 1. Distribution to a United States shareholder.* (i) *Facts.* DP, a United States shareholder, owns 100% of the only class of stock in FC, a CFC. Both DP and FC use the calendar year as their taxable year. FC uses the "u" as its functional currency. During year 1, FC derives 100u of subpart F income, and such amount is included in DP's gross income under section 951(a)(1)(A). The average exchange rate for year 1 is  $1u = \$1$ . At the end of year 1, FC's current and accumulated earnings and profits (before taking into account distributions made during year 1) are 500u. Also, on December 31, year 1, when the spot exchange rate is  $1u = \$1.10$ , FC distributes 50u of earnings and profits to DP.

(ii) *Analysis.* At the end of year 1, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are first increased from 0 to 100u, pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F inclusion of 100u and then reduced from 100u to 50u, pursuant to paragraph (e)(2)(ii) of this section as a result of the distribution. DP's dollar basis in the 100u of previously taxed earnings and profits is \$100 (the dollar amount of the income inclusion under section 951(a)(1)(A)). See section 989(b)(3). The 50u distribution is excluded from DP's gross income pursuant to §1.959-1(c)(1). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of 50u and non-previously taxed earnings and profits of 400u. DP's dollar basis in the previously taxed earnings and profits account is reduced by a *pro rata* share of

the dollar amount included in income under section 951(a)(1)(A), or by \$50 (50u distribution/100u previously taxed earnings and profits x \$100 dollar basis). DP recognizes foreign currency gain under section 986(c) of \$5 (\$55 spot value of 50u distribution - \$50 basis).

*Example 2. Net deficit in earnings and profits.* (i) *Facts.* Assume the same facts as in *Example 1*, except that FC has a net deficit in earnings and profits of 500u for year 2. At the end of Year 1, FC has 50u of section 959(c)(2) earnings and profits and 400u of non-previously taxed earnings and profits.

(ii) *Analysis.* At the end of year 2, DP's section 959(c)(2) earnings and profits for year 1 remains at 50u, pursuant to paragraph (e)(5) of this paragraph, because a shareholder's previously taxed earnings and profits account is not adjusted to take into account the CFC's deficit in earnings and profits. Pursuant to paragraph (e)(4) of this section, at the end of year 2, FC's non-previously taxed earnings and profits are reduced to (100u), and no adjustment is made to FC's previously taxed earnings and profits, which remains at 50u.

*Example 3. Distribution and section 956 inclusion in same year.* Assume the same facts as in *Example 1*, except that DP also has a section 956 amount for year 1 with respect to its stock in FC of 200u.

(i) *Analysis.* At the end of year 1, adjustments are made to DP's previously taxed earnings and profits account in its FC stock in the following order: First, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are increased from 0 to 100u pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F inclusion. Then, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are reduced from 100u to 50u pursuant to paragraph (e)(2)(ii) of this section as a result of the distribution and the 50u distribution is excluded from DP's gross income pursuant to §1.959-1(c)(1). Then, the remaining 50u of section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are reclassified as section 959(c)(1) earnings and profits pursuant to paragraph (e)(2)(iv) of this section as a result of FC's investment in United States property and 50u of the 200u section 956 amount is excluded from DP's gross income pursuant to §1.959-1(c)(2). Finally, the remaining 150u section 956 amount equal to \$165 (150u x 1.1) is included in DP's gross income pursuant to section 951(a)(1)(B) and the section 959(c)(1) earnings and profits in DP's previously taxed earnings and profits account are increased from 50u to 200u pursuant to paragraph (e)(2)(vii) of this section. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(1) earnings and profits of 200u and non-previously taxed earnings and profits of 250u. DP's dollar basis in the previously taxed earnings and profits account at the end of year 1 is \$215 (the \$50 attributable to the reclassified 50u of earnings and \$165 attributable to the 150u of section 956 inclusion). See section 989(b)(4).

*Example 4. Section 956 amount in following year.* (i) *Facts.* Assume the same facts as in *Example 3*, except that in year 2, DP has an additional section 956 amount of 200u with respect to its stock in FC and the spot exchange rate on December 31, year 2 is  $1u = \$1.20$ .

(ii) *Analysis.* As in *Example 3*, at the end of year 1, DP has a section 959(c)(1) earnings and profits account with respect to its stock in FC of 200u. Although DP has 200u of section 959(c)(1) earnings and profits in its previously taxed earnings and profits account with respect to its stock in FC, section 959(c)(1) earnings and profits are generated by the inclusion of a section 956 amount in a United States shareholder's gross income or the reclassification of section 959(c)(2) earnings and profits to exclude a section 956 amount from a United States shareholder's gross income and cannot be used to exclude any additional section 956 amounts from a United States shareholder's gross income. Consequently, at the end of year 2, the section 959(c)(1) earnings and profits in DP's previously taxed earnings and profits account are increased from 200u to 400u pursuant to paragraph (e)(2)(vii) of this section and the 200u section 956 amount is included in DP's gross income pursuant to section 959(a)(1)(B). Pursuant to paragraph (e)(4) of this section, at the end of year 2, FC has section 959(c)(1) earnings and profits of 400u and non-previously taxed earnings and profits of 50u. DP's dollar basis in its 200u of year 2 section 959(c)(1) earnings and profits is \$240.

*Example 5. Section 951(a)(1)(A) inclusion and distribution in following year.* (i) *Facts.* Assume the same facts as in *Example 4*, except that in year 3, FC derives 250u of subpart F income, which is included in DP's income under section 951(a)(1)(A), makes a 250u distribution to DP, and has 700u of current and accumulated earnings and profits (before taking into account distributions made during year 3). The average exchange rate for year 3 is  $1u = \$1.10$ , so DP includes \$275 in income (250u x \$1.10/1u).

(ii) *Analysis.* As in *Example 4*, at the end of year 2, DP has a previously taxed earnings and profits account with respect to its stock in FC of 400u of section 959(c)(1) earnings and profits. At the end of year 3, adjustments are made in the following order. First, DP's section 959(c)(2) earnings and profits are increased from 0 to 250u pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F inclusion. Then the section 959(c)(1) earnings and profits in DP's previously taxed earnings and profits account are reduced from 400u to 150u and the 250u distribution to DP is excluded from DP's gross income pursuant to §1.959-1(c)(1). Pursuant to paragraph (e)(4) of this section, at the end of year 3, FC has 150u of section 959(c)(1) earnings and profits, 250u of section 959(c)(2) earnings and profits, and 50u of non-previously taxed earnings and profits. If DP has not made the dollar basis pooling election described in paragraph (b)(3)(ii) of this section, then the 250u distribution out of section 959(c)(1) earnings is assigned a dollar basis of \$293.75 (\$240 basis in 200u of year 2 earnings and \$53.75 basis in 50u of year 1 earnings (50u/200u x \$215)). DP's remaining dollar basis in the year 1 section 959(c)(1) earnings is \$161.25 (\$215 - \$53.75). If DP elected to maintain the dollar basis of its previously taxed earnings and profits account on a pooled basis as provided in paragraph (b)(3)(ii) of this section, then the 250u distribution out of section 959(c)(1) earnings is assigned a dollar basis of \$280.77 (250u/650u x (\$215 + \$240 + \$275)), and DP's dollar basis in its remaining 400u previously taxed earnings accounts is \$449.23 (\$730 - \$280.77).



*Example 6. Distribution to a United States shareholder and a foreign shareholder.* (i) *Facts.* DP, a United States shareholder, owns 70% and FP, a non-resident alien, owns 30% of the only class of stock in FC, a CFC that uses the U.S. dollar as its functional currency. Both DP and FC use the calendar year as their taxable year. During year 1, FC derives \$100x of subpart F income, \$70x of which is included in DP's gross income under section 951(a)(1)(A). FC's current and accumulated earnings and profits (before taking into account distributions made during year 1) are \$500x. Also, during year 1, FC distributes \$50x of earnings and profits, \$35x distribution to DP and \$15x distribution to FP.

(ii) *Analysis.* At the end of year 1, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are increased from \$0 to \$70x, pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F inclusion. The section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are then reduced from \$70x to \$35x, pursuant to paragraph (e)(2)(ii) of this section as a result of the distribution. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$35x and non-previously taxed earnings and profits of \$415x.

*Example 7. Incorporate Distribution.* (i) *Facts.* DP, a United States shareholder, owns 70% and FP, a nonresident alien, owns 30% of the only class of stock in FC, a CFC. FC owns 100% of the only class of stock in FS, a CFC. FC uses the "u" as its functional currency and FS uses the "y" as its functional currency. DP, FC, and FS all use the calendar year as their taxable year. During year 1, FS derives 100y of subpart F income. The average y:\$ exchange rate for year 1 is 1y = \$1. On December 31, year 2, FS distributes 100y to FC. The y:u exchange rate on December 31, year 2, is 1y = 0.5u.

(ii) *Analysis.* (A) *Year 1.* At the end of year 1, DP's *pro rata* share of 70y of subpart F income is included in DP's gross income pursuant to section 951(a)(1)(A)(i) and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to the stock it indirectly owns in FS are correspondingly increased from 0 to 70y pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F income. The dollar basis of the previously taxed earnings and profits in DP's account with respect to its stock in FS is \$70. At the end of year 2, FS has section 959(c)(2) earnings and profits of 70y and non-previously taxed earnings and profits of 30y.

(B) *Year 2.* Upon the distribution of 100y = 50u from FS to FC on December 31, year 2, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to the stock it indirectly owns in FS are reduced from 70y to 0 and the section 959(c)(2) earnings and profits in DP's earnings and profits account with respect to its stock in FC are correspondingly increased from 0 to 35u pursuant to paragraph (e)(3) of this section. The entire 100y = 50u distribution is excluded from FC's income for purposes of determining FC's subpart F income under section 951(a) for year 2 with respect to DP pursuant to §1.959-2(a)(1). Pursuant to paragraph (e)(4) of this section, at the end of year 2, FS has 0 earnings and profits and FC has section 959(c)(2) earnings and profits of 35u and non-previously taxed

earnings and profits of 15u. DP's dollar basis in its 35u of section 959(c)(2) earnings and profits in its earnings and profits account with respect to its stock in FC is \$70, carried over from DP's original dollar basis in its 70y of section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to its stock in FS.

*Example 8. Sale of CFC stock.* (i) *Facts.* DP1, a United States shareholder, owns 100% of the only class of stock in FC, a CFC. At the beginning of year 1, DP1 has a zero basis in its stock in FC. Both DP1 and FC use the calendar year as their taxable year. FC uses the U.S. dollar as its functional currency. During year 1, FC derives \$100x of subpart F income and \$100x of other income. On December 31 of year 1, DP1 sells all of its stock in FC to DP2, a U.S. person for \$200x. Year 1 is a year beginning on or after December 31, 1962.

(ii) *Analysis.* First, DP1 includes the \$100x of subpart F income in gross income under section 951(a)(1)(A). The section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to its stock in FC are increased from \$0 to \$100x pursuant to paragraph (e)(2)(i) of this section and DP1's basis in its FC stock is increased from \$0 to \$100x pursuant to §1.961-1(b). FC's section 959(c)(2) earnings and profits are increased from \$0 to \$100x and its non-previously taxed earnings and profits are correspondingly increased from \$0 to \$100x pursuant to paragraph (e)(4) of this section. Then pursuant to section 1248(a), because FC has \$100x of non-previously taxed earnings and profits attributable to DP1's stock that are attributable to a taxable year beginning on or after December 31, 1962 during which FC was a CFC and DP1 owned its stock in FC, the \$100x of gain recognized by DP1 on the sale of its stock (\$200x proceeds - \$100x basis) is included in DP1's gross income as a dividend. Consequently, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to its stock in FC are increased from \$100x to \$200x pursuant to paragraph (e)(2)(i) of this section. Upon the sale, DP2 acquires from DP1 a previously taxed earnings and profits account with respect to the FC stock of \$200x of section 959(c)(2) earnings and profits and takes a cost basis of \$200x in the FC stock pursuant to section 1012.

(f) *Special rule for shareholders with more than one previously taxed earnings and profits account.*—(1) *Adjustments for distributions.* If a covered shareholder owns (within the meaning of section 958(a)) more than one share of stock in a foreign corporation as of the last day of the foreign corporation's taxable year, to the extent that the total amount of any distributions of earnings and profits made with respect to any particular share for the foreign corporation's taxable year would exceed the previously taxed earnings and profits account with respect to such share (an excess distribution amount), the following adjustments shall be made:

(i) *Adjustment of other accounts.* The covered shareholder's previously taxed earnings and profits accounts with respect to the shareholder's other shares of stock in the foreign corporation that are owned by the covered shareholder as of the last day of the CFC's taxable year shall be decreased, in the aggregate, by an amount equal to such excess distribution amount, but not below zero. Such decrease shall be made on a *pro rata* basis by reference to the amount of the previously taxed earnings and profits in those other accounts and shall be allocated to the section 959(c)(1) and (c)(2) earnings and profits in those accounts in the same manner as a distribution is allocated to such earnings and profits pursuant to the rules of section 959(c) and paragraph (e)(2)(ii)(A) of this section.

(ii) *Adjustment of deficient account.* The covered shareholder's previously taxed earnings and profits account for the first-mentioned share of stock shall correspondingly be increased by the same amount, and then shall be adjusted to zero as provided under paragraph (e)(2)(ii)(B) of this section.

(2) *Adjustments for section 956 amounts.* If a United States shareholder, who owns more than one share of stock in a CFC as of the last day of the CFC's taxable year, has a section 956 amount with respect to its stock in the CFC for a taxable year, to the extent that the section 956 amount with respect to any particular share of stock exceeds the section 959(c)(2) earnings and profits in such shareholder's previously taxed earnings and profits account with respect to such share (an excess section 956 amount), the covered shareholder's section 959(c)(2) earnings and profits in its previously taxed earnings and profits accounts with respect to its other shares of stock that are owned by the United States shareholder on the last day of the CFC's taxable year shall be reclassified as section 959(c)(1) earnings and profits, in the aggregate, by an amount equal to such excess section 956 amount. Such reclassification shall be made on a *pro rata* basis by reference to the amount of the section 959(c)(2) earnings and profits in each of the United States shareholder's other previously taxed earnings and profits accounts with respect to its stock in the CFC prior to reclassification under this paragraph (f)(2).

(3) *Examples.* The application of this paragraph (f) is illustrated by the following examples:

*Example 1. Two blocks of stock.* (i) *Facts.* DP, a United States shareholder, owns two blocks, block 1 and block 2, of shares of class A stock in FC, a CFC that uses the U.S. dollar as its functional currency. Both DP and FC use the calendar year as their taxable year. Entering year 1, DP has a previously taxed earnings and profits account with respect to its block 1 shares consisting of \$25x of section 959(c)(2) earnings and profits and a previously taxed earnings and profits account with respect to its block 2 shares consisting of \$65x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$90x and non-previously taxed earnings and profits of \$200x. During year 1, FC makes a distribution of earnings and profits on its Class A stock of \$50x on each of block 1 and block 2.

(ii) *Analysis.* First, as a result of the distribution, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are decreased from \$25x to \$0 and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$65x to \$15x pursuant to paragraph (e)(2)(ii) of this section. Because there are insufficient previously taxed earnings and profits with respect to block 1, DP may access its excess previously taxed earnings and profits with respect to its block 2 stock, after taking into account any distributions or section 956 amounts with respect to block 2. Accordingly, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$15x to \$0 pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are increased from \$0 to \$15x and then decreased from \$15x to \$0 pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section. The \$40x (\$25x + \$15x) of the distribution with respect to block 1 and \$50x of the distribution with respect to block 2 are excluded from DP's gross income pursuant to §1.959-1(c)(1). The remaining \$10x of the distribution of earnings and profits with respect to block 1 is included in DP's gross income as a dividend. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$0 and non-previously taxed earnings and profits of \$190x.

*Example 2. Multiple classes of stock.* (i) *Facts.* Assume the same facts as in *Example 1*, except that DP also owns a block, block 3, of class B stock in FC. Entering year 1, DP has a previously taxed earnings and profits account with respect to block 3 consisting of \$60x of section 959(c)(2) earnings and profits. Entering year 1, FC has \$150x of section 959(c)(2) earnings and profits and \$200x of non-previously taxed earnings and profits.

(ii) *Analysis.* First, as in *Example 1*, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are decreased from \$25x to \$0 and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$65x to \$15x pursuant to paragraph (e)(2)(ii) of this section. Because there

are insufficient previously taxed earnings and profits with respect to block 1, DP may access its excess previously taxed earnings and profits with respect to block 2 and block 3, after taking into account any distributions or section 956 amounts with respect to those blocks. In addition, the previously taxed earnings and profits from blocks 2 and 3 are decreased *pro rata* based on the relative previously taxed earnings and profits in the previously taxed earnings and profits accounts with respect to both blocks after taking into account any distributions or section 956 amounts with respect to those blocks. Thus, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$15x to \$10x ( $\$15x/\$75x \times \$25x$ ) and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 3 are decreased from \$60x to \$40x ( $\$60x/\$75x \times \$25x$ ) pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section. The section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$25x and then decreased from \$25x to \$0 pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section. The entire \$50x distribution with respect to block 1 and \$50x distribution with respect to block 2 are excluded from DP's gross income pursuant to §1.959-1(c)(1). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$200x.

*Example 3. Distribution in excess of aggregate previously taxed earnings and profits.* (i) *Facts.* Assume the same facts as in *Example 2*, except that instead of a total distribution of \$100x on Class A shares in year 1, FC makes a total distribution of \$200x on its Class A shares in year 1, consisting of a \$100x distribution to block 1 and a \$100x distribution to block 2.

(ii) *Analysis.* First, as a result of the distribution, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are decreased from \$25x to \$0 and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$65x to \$0 pursuant to paragraph (e)(2)(ii) of this section. Because there are insufficient previously taxed earnings and profits in DP's previously taxed earnings and profits accounts with respect to blocks 1 and 2, DP may access its excess previously taxed earnings and profits in its previously taxed earnings and profits account with respect to block 3 after taking into account any distributions or section 956 amounts with respect to block 3. Consequently, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 3 are decreased from \$60x to \$0 pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section. Of the total \$200x distribution from FC to DP, \$150x is excluded from DP's gross income pursuant to §1.959-1(c)(1). The remaining \$50x of the distribution is included in DP's gross income pursuant to section 951(a)(1)(A). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$0 and non-previously taxed earnings and profits of \$150x.

*Example 4. Sale.* (i) *Facts.* Assume the same facts as in *Example 2*, except that DP sells block 3 before the end of year 1.

(ii) *Analysis.* First, as in *Example 2*, the distribution results in a decrease of the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 from \$25x to \$0 and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 from \$65x to \$15x pursuant to paragraph (e)(2)(ii) of this section. Because DP does not own block 3 on the last day of year 1, DP cannot use the previously taxed earnings and profits account with respect to block 3 to exclude a distribution in that year to block 1 or 2 from gross income. Therefore, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$15x to \$0 pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$15x and then decreased from \$15x to \$0 pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section. The \$40x (\$25x + \$15x) of the distribution with respect to block 1 and \$50x of the distribution with respect to block 2 are excluded from DP's gross income pursuant to §1.959-1(c)(1). The remaining \$10x of the distribution with respect to block 1 is included in DP's gross income as a dividend. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$60x and non-previously taxed earnings and profits of \$190x.

*Example 5. Section 956 amount.* (i) *Facts.* Assume the same facts as in *Example 2*, except that, in addition, during year 1, FC has a section 956 amount of \$30x, \$5x of which is allocable to each of blocks 1 and 2, and \$20x of which is allocable to block 3.

(ii) *Analysis.* Pursuant to paragraph (f)(2) of this section, account adjustments are made for the distribution from FC before any account adjustments are made for the section 956 amount. After account adjustments are made for the distribution from FC as illustrated in *Example 2*, DP has a previously taxed earnings and profits account with respect to each block as follows: block 1: \$0, block 2: \$10x of section 959(c)(2) earnings and profits, block 3: \$40x of section 959(c)(2) earnings and profits. As a result of the section 956 amount with respect to block 2, pursuant to paragraph (e)(2)(vi) of this section, \$5x of DP's section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to block 2 is reclassified as section 959(c)(1) earnings and profits. Consequently, block 2 is left with a previously taxed earnings and profits account consisting of \$5x of section 959(c)(1) earnings and profits and \$5x of section 959(c)(2) earnings and profits. In addition, pursuant to paragraph (e)(2)(vi) of this section, \$20x of DP's section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to block 3 are reclassified as section 959(c)(1) earnings and profits. Consequently, block 3 is left with a previously taxed earnings and profits account consisting of \$20x of section 959(c)(1) earnings and profits and \$20x of section 959(c)(2) earnings and profits. The total \$25x section 956 amount with respect to blocks 2 and 3 is excluded from DP's gross income pursuant to §1.959-1(c)(2). Because there are insufficient

previously taxed earnings and profits in the previously taxed earnings and profits account with respect to block 1, DP may access its excess previously taxed earnings and profits in the previously taxed earnings and profits accounts with respect to blocks 2 and 3 after taking into account any distributions or section 956 amounts with respect to those blocks. In addition, the previously taxed earnings and profits in the previously taxed earnings and profits accounts with respect to blocks 2 and 3 are reclassified *pro rata* based on the relative previously taxed earnings and profits in those accounts after taking into account any distributions or section 956 amounts with respect to those blocks. Accordingly, pursuant to paragraphs (e)(2)(vi) and (f)(2) of this section, an additional \$1x ( $\$5x/\$25x \times \$5x$ ) of the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are reclassified as section 959(c)(1) earnings and profits and an additional \$4x ( $\$20x/\$25x \times \$5x$ ) of the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 3 are reclassified as section 959(c)(1) earnings and profits. The \$5x section 956 amount with respect to block 1 is also excluded from DP's gross income pursuant to §1.959-1(c)(2). At the end of year 1, DP's previously taxed earnings and profits accounts with respect to its various blocks of stock are as follows: block 1 has no previously taxed earnings and profits, block 2 has \$6x ( $\$5x + \$1x$ ) of section 959(c)(1) earnings and profits and \$4x ( $\$5x - \$1x$ ) of section 959(c)(2) earnings and profits and block 3 has \$24x ( $\$20x + \$4x$ ) of section 959(c)(1) earnings and profits and \$16x ( $\$20x - \$4x$ ) of section 959(c)(2) earnings and profits. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has \$30x of section 959(c)(1) earnings and profits, \$20x of section 959(c)(2) earnings and profits, and \$200x of non-previously taxed earnings and profits.

(g) *Special rule for shareholder included in a consolidated group*—(1) *Adjustments for distributions*—(i) *In general*. In the case of a covered shareholder who is a member of a consolidated group, to the extent that the total amount of any distributions of earnings and profits with respect to such covered shareholder's stock in a foreign corporation during such foreign corporation's taxable year would exceed the covered shareholder's previously taxed earnings and profits account with respect to all of the covered shareholder's stock of the foreign corporation (an excess distribution amount) the previously taxed earnings and profits accounts of the covered shareholder and of the other members of the covered shareholder's consolidated group that own stock in the same foreign corporation and are members of the covered shareholder's consolidated group on the last day of the foreign corporation's taxable year shall be adjusted as follows.

(A) *Adjustment of other members' accounts*. The previously taxed earnings and

profits accounts of the other members of the consolidated group that own (within the meaning of section 958(a)) stock in the same foreign corporation and are members of the covered shareholder's consolidated group on the last day of the foreign corporation's taxable year shall be decreased, in the aggregate, by the amount of such excess distribution amount, but not below zero. Such decrease shall be made on a *pro rata* basis by reference to the amount of such other members' previously taxed earnings and profits accounts and shall be allocated to the section 959(c)(1) and (c)(2) earnings and profits in such accounts in the same manner as a distribution is allocated to such earnings and profits pursuant to section 959(c) and paragraph (e)(2)(ii)(A) of this section.

(B) *Adjustment of the deficient account*. The deficient previously taxed earnings and profits account of such covered shareholder shall correspondingly be increased by the same amount, and then adjusted to zero under paragraph (e)(2)(ii)(B) of this section.

(ii) *Insufficient previously taxed earnings and profits*. If more than one member of the consolidated group is a covered shareholder that has an excess distribution amount with respect to all of its stock in the foreign corporation and there is insufficient previously taxed earnings and profits available in the previously taxed earnings and profits accounts of other consolidated group members to exclude the combined excess distribution amounts of the covered shareholders, the other consolidated group members' previously taxed earnings and profits shall be allocated between the covered shareholders' deficient previously taxed earnings and profits accounts in proportion to each covered shareholder's excess distribution amount.

(2) *Adjustments for section 956 amounts*—(i) *In general*. If a United States shareholder, who is a member of a consolidated group, has a section 956 amount with respect to its stock in a CFC for a taxable year, to the extent that the section 956 amount exceeds the section 959(c)(2) earnings and profits in such United States shareholder's previously taxed earnings and profits accounts with respect to all of its stock in the CFC (an excess section 956 amount), the section 959(c)(2) earnings and profits in the previously taxed earnings and profits accounts of consolidated

group members, who are members of the United States shareholder's consolidated group on the last day of the CFC's taxable year, with respect to their stock in the CFC shall be reclassified as section 959(c)(1) earnings and profits, in the aggregate, by an amount equal to such excess section 956 amount. The amount that is reclassified with respect to each such account of such other members shall be proportionate to the amount of section 959(c)(2) earnings and profits in those accounts prior to reclassification under this paragraph (g).

(ii) *Insufficient section 959(c)(2) earnings and profits*. If more than one member of the consolidated group is a United States shareholder that has an excess section 956 amount with respect to its stock in the CFC for the taxable year and there is insufficient aggregate section 959(c)(2) earnings and profits in other consolidated group members' previously taxed earnings and profits accounts to exclude the combined excess section 956 amounts of the United States shareholders, the amount of any consolidated group members' section 959(c)(2) earnings and profits that are reclassified on behalf of each United States shareholder shall be proportionate to the excess section 956 amount for each such United States shareholder.

(3) *Stock basis adjustments of members*. See §1.1502-32 for rules addressing investment adjustments resulting from the application of this paragraph.

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

*Example 1. Two consolidated group members.* (i) *Facts*. DP1, a United States shareholder, owns one block, block 1, of shares of Class A stock in FC, a CFC that uses the U.S. dollar as its functional currency. DP2, a United States shareholder and a member of DP1's consolidated group, owns one block, block 2, of shares of Class A stock in FC. DP1, DP2 and FC all use the calendar year as their taxable year and FC uses the U.S. dollar as its functional currency. Entering year 1, DP1 has a previously taxed earnings and profits account with respect to block 1 consisting of \$50x of section 959(c)(2) earnings and profits and DP2 has a previously taxed earnings and profits account with respect to block 2 consisting of \$200x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$250x and non-previously taxed earnings and profits of \$100x. In year 1, FC generates no earnings and profits and makes a distribution of earnings and profits on its Class A stock, a \$100x distribution of earnings and profits to block 1 and a \$100x distribution of earnings and profits to block 2.

(ii) *Analysis*. First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earn-

ings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$50x to \$0 and the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$200x to \$100x. Then, pursuant to paragraphs (e)(2)(v) and (g)(1)(i)(A) of this section, the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$100x to \$50x and, pursuant to paragraphs (e)(2)(ii)(B) and (g)(1)(i)(B) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$50x and then decreased from \$50x to \$0. Pursuant to section 959(a) and §1.959-1(c), the entire \$100x distribution to block 1 and \$100x distribution to block 2 are excluded from DP1's and DP2's gross incomes respectively. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$100x.

*Example 2. Two consolidated group members; multiple classes of stock.* (i) *Facts.* Assume the same facts as in *Example 1*, except that DP1 also owns one block, block 3, of shares of class B stock in FC. DP1 has a previously taxed earnings and profits account with respect to block 3 consisting of \$40x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$290x and non-previously taxed earnings and profits of \$100x.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$50x to \$0 and the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$200x to \$100x. Then, pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 3 are decreased from \$40x to \$0 and, pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$40x and then decreased from \$40x to \$0. Finally, pursuant to paragraphs (e)(2)(v) and (g)(1)(i)(A) of this section, the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$100x to \$90x and, pursuant to paragraphs (e)(2)(ii)(B) and (g)(1)(i)(B) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$10x and then decreased from \$10x to \$0. Pursuant to section 959(a) and §1.959-1(c), the entire \$100x distribution to block 1 and \$100x distribution to block 2 are excluded from DP1's and DP2's gross incomes respectively. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$90x and non-previously taxed earnings and profits of \$100x.

*Example 3. Three consolidated group members; multiple classes of stock.* (i) *Facts.* Assume the same

facts as in *Example 2*, except that DP3, a United States shareholder and a member of DP1's consolidated group, owns one block, block 4, of shares of class B stock in FC. DP3 has a previously taxed earnings and profits account with respect to block 4 consisting of \$25x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$315x and non-previously taxed earnings and profits of \$100x.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$50x to \$0 and the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$200x to \$100x. Then, pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 3 are decreased from \$40x to \$0 and, pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$40x and then decreased from \$40x to \$0. Finally, pursuant to paragraphs (e)(2)(v) and (g)(1)(i)(A) of this section, the section 959(c)(2) earnings and profits in DP2's and DP3's previously taxed earnings and profits accounts with respect to blocks 2 and 4 are decreased *pro rata* from \$100x to \$92x and from \$25x to \$23x respectively, and, pursuant to paragraphs (e)(2)(ii)(B) and (g)(1)(i)(B) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$10x and then decreased from \$10x to \$0. Pursuant to section 959(a) and §1.959-1(c), the entire amounts of the \$100x distribution to block 1 and the \$100x distribution to block 2 are excluded from DP1's and DP2's gross incomes respectively. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$115x and non-previously taxed earnings and profits of \$100x.

*Example 4. Section 956 Amount.* (i) *Facts.* Assume the same facts as in *Example 3*, except that instead of a distribution of 200x on its class A stock, FC has a section 956 amount for year 1 of \$180x, 45x of which is allocable to each of blocks 1 through 4.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(iv) of this section, the section 959(c)(2) earnings and profits in each shareholder's previously taxed earnings profits account are reclassified as section 959(c)(1) earnings and profits leaving each block of stock with the following account: block 1: \$45x of section 959(c)(1) earnings and profits, \$5x of section 959(c)(2) earnings and profits; block 2: \$45x of section 959(c)(1) earnings and profits and \$155x of section 959(c)(2) earnings and profits; block 3: \$40x of section 959(c)(1) earnings and profits and \$0 of section 959(c)(2) earnings and profits; block 4: \$25x of section 959(c)(1) earnings and profits and \$0 of section 959(c)(2) earnings and profits. After the above reclassifications, DP1 has an excess section 956 amount of \$5x with respect to block 3. Therefore, pursuant to paragraphs (e)(2)(vi) and (f)(2) of this section, the remaining \$5x of section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to

block 1 are reclassified as section 959(c)(1) earnings and profits, leaving DP1 with \$50x of section 959(c)(1) earnings and profits and \$0 of section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to block 1. The entire \$45x section 956 amount with respect to blocks 1 and 3 are excluded from DP1's gross income pursuant to paragraph (c)(2) of this section. After the above reclassifications, DP3 has an excess section 956 amount of \$20x with respect to block 4. Therefore, pursuant to paragraphs (e)(2)(vi) and (g)(2)(i) of this section, \$20x of the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are reclassified as section 959(c)(1) earnings and profits, leaving DP2 with \$65x of section 959(c)(1) earnings and profits and \$135x of section 959(c)(2) earnings and profits. The entire \$45x section 956 amount with respect to blocks 2 and 4 are excluded from DP2's and DP3's gross incomes, respectively, pursuant to §1.959-1(c)(2). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(1) earnings and profits of \$180x, section 959(c)(2) earnings and profits of \$135x, and non-previously taxed earnings and profits of \$100x.

*Example 5. Ex-member.* (i) *Facts.* DP1, a United States shareholder, owns one block, block 1, of shares of Class A stock in FC, a CFC that uses the U.S. dollar as its functional currency. DP2 and DP3, both United States shareholders and members of DP1's consolidated group, own one block each, blocks 2 and 3 respectively, of shares of Class A stock in FC. DP1, DP2, DP3 and FC all use the calendar year as their taxable year. Entering year 1, DP1 has a previously taxed earnings and profits account with respect to block 1 consisting of \$50x of section 959(c)(2) earnings and profits, DP2 has a previously taxed earnings and profits account with respect to block 2 consisting of \$100x of section 959(c)(2) earnings and profits, and DP3 has a previously taxed earnings and profits account with respect to block 3 consisting of \$200x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$350x and non-previously taxed earnings and profits of \$100x. On March 15 of year 1, FC makes a distribution of earnings and profits on its Class A stock consisting of a \$100x distribution of earnings and profits to each of blocks 1, 2 and 3. On July 4 of year 1, DP3 is sold to DP4, a United States person who is not a member of the consolidated group, and DP3 ceases to be a member of the consolidated group.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$50x to \$0, the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$100x to \$0, and the section 959(c)(2) earnings and profits in DP3's previously taxed earnings and profits account with respect to block 3 are decreased from \$200x to \$100x. Because DP3 was not a member of DP1's consolidated group on the last day of year 1, the remaining \$100x of section 959(c)(2) earnings and profits in DP3's previously taxed earnings and profits account with respect to its stock in FC cannot be used to exclude the remaining \$50x distribution to DP1 from DP1's gross income. Consequently, pursuant to §1.959-1(c)(1),

\$50x of the distribution to block 1, the entire \$100x of the distribution to block 2, and the entire \$100x of the distribution to block 3 are excluded from DP1's, DP2's, and DP3's gross incomes respectively. The remaining \$50x distribution to DP1 is included in DP1's gross income pursuant to section 951(a)(1)(a). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$150x and non-previously taxed earnings and profits of \$50x.

*Example 6. Insufficient excess previously taxed earnings and profits.* (i) *Facts.* DP1, a United States shareholder, owns one block, block 1, of shares of Class A stock in FC, a CFC that uses the U.S. dollar as its functional currency. DP2 and DP3, both United States shareholders and members of DP1's consolidated group, own one block each, blocks 2 and 3 respectively, of shares of Class A stock in FC. DP1, DP2, DP3 and FC all use the calendar year as their taxable year. Entering year 1, DP1 has a previously taxed earnings and profits account with respect to block 1 consisting of \$40x of section 959(c)(2) earnings and profits, DP2 has a previously taxed earnings and profits account with respect to block 2 consisting of \$60x of section 959(c)(2) earnings and profits, and DP3 has a previously taxed earnings and profits account with respect to block 3 consisting of \$150x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$250x and non-previously taxed earnings and profits of \$100x. On March 15 of year 1, FC makes a distribution of earnings and profits on its Class A stock consisting of a \$100x distribution of earnings and profits to each of blocks 1, 2 and 3.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$40x to \$0, the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$60x to \$0, and the section 959(c)(2) earnings and profits in DP3's previously taxed earnings and profits account with respect to block 3 are decreased from \$150x to \$50x. Then, pursuant to paragraph (g)(1)(i)(A) of this section, the section 959(c)(2) earnings and profits in DP3's previously taxed earnings and profits account with respect to its stock in FC are reduced from \$50x to \$0 and, pursuant to paragraphs (g)(1)(i)(B) and (g)(1)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's and DP2's previously taxed earnings and profits accounts with respect to their stock in FC are increased from \$0 to \$30x ( $\$60x / \$100x \times \$50x$ ) and \$0 to \$20x ( $\$40x / \$100x \times \$50x$ ) respectively and then immediately reduced to \$0. Pursuant to §1.959-1(c), \$70x ( $\$40x + \$30x$ ) of the distribution to DP1, \$80x ( $\$60x + \$20x$ ) of the distribution to DP2, and \$100x of the distribution to DP3 are excluded from gross income. The remaining \$30x distributed to DP1 and \$20x distributed to DP2 are included in gross income pursuant to section 951(a)(1)(A). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has non-previously taxed earnings and profits of \$50x.

(h) *Adjustments in the case of redemptions—(1) In general.* In the case of a foreign corporation's redemption of stock

(a redemption distribution), the effect on the covered shareholder's previously taxed earnings and profits account and on the earnings and profits of the redeeming corporation depends on whether the distribution is treated as a payment in exchange for stock or as a distribution of property to which section 301 applies. For the treatment of deemed redemption distributions in transactions described in section 304(a)(1), see paragraph (h)(4) of this section.

(2) *Exchange treatment—(i) Effect on foreign corporation's earnings and profits.* In the case of a redemption distribution that is treated as a payment in exchange for stock under section 302(a) or section 303, the amount of the distribution properly chargeable to the earnings and profits of the redeeming foreign corporation is the amount determined under section 312(a), subject to the limitation in section 312(n)(7) and this paragraph (h)(2)(i). For purposes of section 312(n)(7), the amount properly chargeable to the earnings and profits of the redeeming foreign corporation shall not exceed the sum of—

(A) The amount of the previously taxed earnings and profits account with respect to the redeemed shares of stock (without adjustment for any income inclusion under section 1248 resulting from the redemption); and

(B) A ratable portion of the redeeming corporation's non-previously taxed earnings and profits. Such chargeable amount of earnings and profits shall be allocated to earnings and profits in accordance with section 959(c) and this section.

(ii) *Cessation of previously taxed earnings and profits account.* In the case of a redemption distribution that is treated as a payment in exchange for stock, the redeemed covered shareholder's previously taxed earnings and profits account with respect to the redeemed shares ceases to exist and is not transferred to any other previously taxed earnings and profits account. In such a case, any previously taxed earnings and profits in the redeemed covered shareholder's previously taxed earnings and profits account, after being reduced under paragraph (h)(2)(i) of this section, become non-previously taxed earnings and profits of the foreign corporation.

(iii) *Examples.* The application of this paragraph (h)(2) is illustrated by the following examples:

*Example 1. Complete redemption treated as exchange; previously taxed earnings and profits account is depleted.* (i) *Facts.* DP, a United States shareholder, owns 70% and FP, a nonresident alien who is unrelated to DP under section 318, owns 30% of the only class of stock in FC, a CFC that uses the U.S. dollar as its functional currency. Both DP and FC use the calendar year as their taxable year and both DP and FC are wholly owned by the same domestic corporation, USP. DP has a previously taxed earnings and profits account consisting of \$50x of section 959(c)(2) earnings and profits with respect to its stock in FC and DP has a \$50 basis in its FC stock pursuant to section 961(a). FC has \$50x of section 959(c)(2) earnings and profits and \$50x of non-previously taxed earnings and profits attributable to taxable years of FC beginning on or after December 31, 1962 during which FC was a CFC and during which DP held its shares of stock in FC. FC redeems all of DP's stock for \$100x in a redemption that is treated as a payment in exchange for the stock under section 302(a).

(ii) *Analysis.* DP includes \$35x ( $\$50x \times 70%$ ) in gross income as a dividend pursuant to section 1248(a) as a result of the deemed exchange. FC adjusts its earnings and profits as a result of the exchange under paragraph (h)(2)(i) of this section in the following manner: first, FC's section 959(c)(2) earnings and profits are reduced from \$50x to \$0; then, FC's non-previously taxed earnings and profits are decreased from \$50x to \$15x to reflect DP's \$35x ratable share of FC's non-previously taxed earnings and profits. DP's previously taxed earnings and profits account ceases to exist and is not transferred to any other previously taxed earnings and profits account.

*Example 2. Complete redemption treated as exchange; previously taxed earnings and profits account is not depleted.* (i) *Facts.* Assume the same facts as *Example 1*, except that the amount of the redemption distribution by FC to DP is \$25x.

(ii) *Analysis.* DP recognizes a \$25x loss as a result of the deemed exchange. FC's section 959(c)(2) earnings and profits are decreased from \$50x to \$25x, pursuant to paragraph (h)(2)(i) of this section. DP's previously taxed earnings and profits account ceases to exist, and the remaining \$25x of section 959(c)(2) earnings and profits in such account is not transferred to any other previously taxed earnings and profits account. However, pursuant to paragraph (h)(2)(ii) of this section, the \$25x of previously taxed earnings and profits is converted to non-previously taxed earnings and profits of DC.

(3) *Distribution treatment—(i) Adjustment of shareholder previously taxed earnings and profits accounts and foreign corporation's earnings and profits.* In the case of a redemption distribution by a foreign corporation that is treated as a distribution of property to which section 301 applies, §1.959-1 and this section shall apply in the same manner as they would apply to any distribution of property to which section 301 applies.

(ii) *Transfer to remaining shares.* To the extent that the previously taxed earnings and profits account with respect to

stock redeemed in a transaction described in paragraph (h)(3)(i) of this section exceeds the amount chargeable to the earnings and profits of the corporation under the rules of that paragraph, the excess previously taxed earnings and profits shall be reallocated to the previously taxed earnings and profits accounts with respect to the remaining stock in the foreign corporation in a manner consistent with, and in proportion to, the proper adjustments of the basis in the remaining shares pursuant to §1.302-2(c).

(iii) *Examples.* The application of this paragraph (h)(3) is illustrated by the following examples:

*Example 1. Redemption in exchange for cash that is treated as a distribution.* (i) *Facts.* DP, a United States shareholder, owns 100% of the stock in FC, a CFC that uses the U.S. dollar as its functional currency. Both DP and FC use the calendar year as their taxable year. DP owns two blocks of stock in FC, block 1 and block 2. At the beginning of year 1, DP has a previously taxed earnings and profits account with respect to block 1 consisting of \$50x of section 959(c)(2) earnings and profits and FC has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$100x. In year 1, FC redeems block 1 for \$100x in a redemption that is treated as a distribution of property to which section 301 applies under section 302(d).

(ii) *Analysis.* The section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are reduced from \$50x to \$0 and FC's section 959(c)(2) earnings and profits are correspondingly reduced from \$50x to \$0. The remaining \$50x is included in DP's gross income as a dividend under section 301(c)(1) and FC's non-previously taxed earnings and profits are reduced from \$100x to \$50x.

*Example 2. Redemption in exchange for cash that is treated as a distribution.* (i) *Facts.* Assume the same facts as *Example 1*, except that DP is redeemed for \$25x.

(ii) *Analysis.* The section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are reduced from \$50x to \$25x and FC's section 959(c)(2) earnings and profits are correspondingly reduced from \$50x to \$25x. FC's non-previously taxed earnings and profits remain at \$100x. Pursuant to paragraph (h)(3)(ii) of this section the remaining \$25x of section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are reallocated with respect to the remaining stock in FC in a manner consistent with, and in proportion to, the proper adjustments of the basis of the remaining FC shares pursuant to §1.302-2(c).

(4) *Section 304 transactions—(i) Deemed redemption treated as a distribution.* In the case of a stock acquisition described in section 304(a)(1), that is treated as a distribution of property to which section 301 applies, a covered shareholder receiving an amount treated

as a distribution of earnings and profits shall have a previously taxed earnings and profits account with respect to stock in each foreign corporation treated as distributing its earnings and profits under section 304(b)(2), even if such person did not otherwise have a previously taxed earnings and profits account with respect to stock in such corporation or corporations. In such a case, §1.959-1 and this section shall apply in the same manner as these regulations would apply to any distribution to which section 301 applies.

(ii) *Example.* The application of this paragraph (h)(4) is illustrated by the following example:

*Example. Cross-chain acquisition of first-tier CFC.* (i) *Facts.* DP, a domestic corporation, owns all of the stock in DS, a domestic corporation, and F1, a CFC. DP and DS are members of the same consolidated group. DS owns all of the stock in F2, a CFC. DP, DS, F1 and F2 all use the calendar year as their taxable year and F1 and F2 each use the U.S. dollar as its functional currency. During year 1, F1 purchases all the stock in F2 from DS for \$80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of F2's stock, DP has a previously taxed earnings and profits account consisting of \$20x of section 959(c)(2) earnings and profits with respect to its stock in F1, and F1 has previously taxed earnings and profits consisting of \$20x of section 959(c)(2) earnings and profits and non-previously taxed earnings and profits of \$10x. At the end of year 1, before taking into account the purchase of F2's stock, DS has a previously taxed earnings and profits account consisting of \$50x of section 959(c)(2) earnings and profits with respect to its stock in F2, and F2 has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$0.

(ii) *Analysis.* Under section 304(a)(1), DS is deemed to have transferred the F2 stock to F1 in exchange for F1 stock in a transaction to which section 351(a) applies, and F1 is treated as having redeemed, for \$80x, the F1 stock deemed issued to DS. The payment of \$80x is treated as a distribution of property to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend is made as if the distribution were made, first, by F1 to the extent of its earnings and profits (\$30x), and then by F2 to the extent of its earnings and profits (\$50x). Before taking into account the deemed distributions, DS had a previously taxed earnings and profits account consisting of \$50x of section 959(c)(2) earnings and profits with respect to its stock in F2, and DP had a previously taxed earnings and profits account consisting of \$20x of section 959(c)(2) earnings and profits with respect to its stock in F1. Under paragraph (h)(4)(i) of this section, DS has a previously taxed earnings and profits account with respect to the stock in F1. Under paragraph (g)(1)(i) of this section, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to the F1 stock are reduced from \$20x to \$0 and the section 959(c)(2) earnings and profits in DS's previously

taxed earnings and profits account with respect to the F1 stock are increased from \$0 to \$20x. The distribution by F1 causes the section 959(c)(2) earnings and profits in DS's previously taxed earnings and profits account with respect to F1 stock to be reduced from \$20x to \$0, and causes F1's section 959(c)(2) earnings and profits to be reduced from \$20x to \$0 and its non-previously taxed earnings and profits to be reduced from \$10x to \$0. The deemed distribution by F2 causes the section 959(c)(2) earnings and profits in DS's previously taxed earnings and profits account with respect to F2 stock to be reduced from \$50x to \$0, and causes F2's section 959(c)(2) earnings and profits to be reduced from \$50x to \$0. Of the distribution of \$80x, \$70x is excluded from DS's gross income pursuant to §1.959-1(c)(1), and \$10x is included in DS's gross income as a dividend.

Par. 5. Section 1.959-4 is revised to read as follows:

*§1.959-4 Distributions of amounts excluded under section 959(a).*

Except as provided in section 960(a)(3) and §1.960-1, any distribution excluded from gross income of a covered shareholder under section 959(a)(1) and §1.959-1(c)(1) shall be treated, for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Internal Revenue Code as a distribution which is not a dividend, except such a distribution shall immediately reduce earnings and profits.

Par. 6. Section 1.961-1 is revised to read as follows:

*§1.961-1 Increase in basis of stock in CFCs and of other property.*

(a) *Definitions.* See §1.959-1(b) for a list of defined terms applicable to §1.961-1 through §1.961-4.

(b) *Increase in basis—(1) In general.* Except as provided in paragraphs (b)(2) and (b)(3) of this section, the adjusted basis of a United States shareholder's stock in a CFC or property (as defined in paragraph (c)(1) of this section) by reason of the ownership of which such United States shareholder is considered under section 958(a) as owning stock in a CFC shall be increased under section 961(a) each time, and to the extent that, such United States shareholder's previously taxed earnings and profits account with respect to the stock in that CFC is increased pursuant to the steps outlined in §1.959-3(e)(2).

(2) *Limitation on amount of increase in case of election under section 962.* [Reserved].

(3) *Deemed inclusions under sections 1293(c) and 959(e).* Paragraph (b)(1) of this section shall not apply in the case of a deemed section 951(a) inclusion pursuant to section 1293(c) or 959(e).

(c) *Rules of application*—(1) *Property defined.* The property of a United States shareholder referred to in paragraph (b)(1) of this section shall consist of—

(i) Stock in a foreign corporation;

(ii) An interest in a foreign partnership; or

(iii) A beneficial or ownership interest in a foreign estate or trust (as defined in section 7701(a)(31)).

(2) *Increase with respect to each share or ownership unit.* Any increase under paragraph (b) of this section in the basis of a United States shareholder's stock in a foreign corporation or property (as defined in paragraph (c)(1) of this section) by reason of the ownership of which such United States shareholder is considered under section 958(a) as owning stock in a foreign corporation shall be made on a *pro rata* basis with respect to each share of such stock or each ownership unit of such property.

(3) *Translation rules.* For purposes of determining an increase in basis under this section, in cases in which the previously taxed earnings and profits account is maintained in a non-United States dollar functional currency, section 951(a) inclusions shall be translated into United States dollars at the appropriate exchange rate as described in section 989(b). Any other increase in basis pursuant to paragraph (b) of this section (for example, a basis increase resulting from the application of §1.959-3(f) or (g)) shall be in the amount of the transferor's dollar basis attributable to the previously taxed earnings and profits transferred.

(c) *Examples.* The application of this section is illustrated by the following examples:

*Example 1. Basis adjustment for income inclusion.* (i) *Facts.* DP, a United States shareholder, owns 800 of the 1,000 shares of the one class of stock in FC and has a basis of \$50 in each of its shares. DP and FC use the calendar year as a taxable year and FC is a CFC. FC uses the u as its functional currency. The average exchange rate for year 1 is  $1u = \$1$ . In year 1, its first year of operation, FC has 100,000u of subpart F income after the payment of 11,250u of foreign income taxes. DP is required to include in gross income 80,000u ( $800/1,000 \times 100,000u$ ) equal to \$80,000 under section 951(a), and 9,000u ( $80,000u/100,000u \times 11,250u$ ) equal to \$9,000 under section 78.

(ii) *Analysis.* On December 31, of year 1, DP increases the section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to its stock in FC by 80,000u pursuant to §1.959-3(e)(2)(i) to reflect the inclusion of 80,000u, or \$80,000, in DP's gross income pursuant to section 959(a), and correspondingly increases the basis of each share of its stock in FC by \$100 (\$80,000/800) from \$50 to \$150 pursuant to paragraphs (b)(1) and (c)(2) of this section.

*Example 2. Sale of CFC stock.* (i) *Facts.* Assume the same facts as in *Example 1*, except that in year 2, DP sells all of its stock in FC to DP2, a United States person that is DP's successor in interest (as defined in §1.959-1(b)(5)), for \$200 per share. At the time of sale, the exchange rate is  $1u = \$1$  and DP has a basis of \$150 per share in its FC stock and a previously taxed earnings and profits account with respect to its FC stock consisting of 80,000u of section 959(c)(2) earnings and profits with a dollar basis of \$80,000. Also, at the time of sale, FC has 50,000u of non-previously taxed earnings and profits, attributable to taxable years of FC beginning on or after December 31, 1962 during which FC was a CFC and DP held its shares of stock in FC.

(ii) *Analysis.* Pursuant to section 1248(a), because FC has 40,000u of non-previously taxed earnings and profits attributable to DP's stock ( $50,000u \times 800/1,000$ ), the \$40,000 of gain, equal to 40,000u, recognized by DP on the sale of its stock ( $(\$200 - \$150) \times 800$ ) is included in DP's gross income as a dividend. Consequently, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FC are increased from 80,000u to 120,000u pursuant to §1.959-3(e)(2)(i). DP's basis in each share of its stock in FC is not adjusted, pursuant to paragraph (b)(3) of this section, because the adjustment to DP's previously taxed earnings and profits account results from a deemed section 951(a) inclusion pursuant to section 959(e). Upon the sale, DP2 acquires a previously taxed earnings and profits account with respect to the FC stock of 120,000u pursuant to §1.959-1(d)(2)(i) and can utilize the account if it qualifies as a successor in interest under §1.959-1(b)(5). DP2 takes a cost basis of \$200 per share in the FC stock pursuant to section 1012.

Par. 7. Section 1.961-2 is revised to read as follows:

*§1.961-2 Reduction in basis of stock in foreign corporations and of other property.*

(a) *Reduction in basis*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, the adjusted basis of a covered shareholder's stock in a foreign corporation or property (as defined in §1.961-1(c)) by reason of the ownership of which such covered shareholder is considered under section 958(a) as owning stock in a foreign corporation shall be reduced under section 961(b) each time, and to the extent, that such covered shareholder's dollar basis in a previously

taxed earnings and profits account with respect to the stock in such foreign corporation is decreased pursuant to the steps outlined in §1.959-3(e)(2) and shall also be reduced by the dollar amount of any foreign income taxes allowed as a credit under section 960(a)(3) with respect to the earnings and profits accounted for by that decrease.

(2) *Limitation on amount of reduction in case of election under section 962.* [Reserved].

(b) *Rules of application*—(1) *Reduction with respect to each ownership unit.* Any reduction under paragraph (a) of this section in the adjusted basis of a covered shareholder's stock in a foreign corporation or property (as defined in paragraph (b)(1) of this section) by reason of the ownership of which it is considered under section 958(a) as owning stock in a foreign corporation shall be made on a *pro rata* basis with respect to each share of such stock or each ownership unit of such property.

(2) *Translation rules.* For purposes of determining a decrease in basis under this section, in cases in which the previously taxed earnings and profits account is maintained in a non-United States dollar functional currency, distributions of previously taxed earnings and profits shall be translated using the dollar basis of the earnings distributed. See §1.959-3(b)(1) and (b)(3)(ii) for rules regarding the dollar basis of previously taxed earnings and profits. If the covered shareholder elects to maintain dollar basis accounts of previously taxed earnings and profits as described in § 1.959-3(b)(3)(ii), the dollar basis of the earnings distributed shall be determined according to the following formula: (functional currency distributed/total functional currency previously taxed earnings and profits) x total dollar basis of previously taxed earnings and profits. See section 989(b)(1) for the appropriate exchange rate applicable to distributions for purposes of section 986(c).

(c) *Amount in excess of basis.* To the extent that the amount of the reduction in the adjusted basis of property provided by paragraph (a) of this section exceeds such adjusted basis, the amount shall be treated as gain from the sale or exchange of property.

(d) *Examples.* The application of this section is illustrated by the following examples:

*Example 1. Successor in interest.* (i) *Facts.* DP, a United States shareholder, owns all of the 1,000 shares of the one class of stock in FC, which owns all of the 500 shares of the one class of stock in FS. Each share of DP's stock in FC has a basis of \$200. DP, FC, and FS use the calendar year as a taxable year and FC and FS are CFCs throughout the period here involved. FC and FS both use the u as their functional currency. In year 1, FS has 100,000u of subpart F income after the payment of 50,000u of foreign income taxes. The average exchange rate for year 1 and year 2 is 1u = \$1. For year 1, DP includes 100,000u in gross income under section 951(a) with respect to FS. In accordance with the provisions of §1.961-1, DP increases the basis of each of its 1,000 shares of stock in FC to \$300 ( $\$200 + \$100,000/1,000$ ) as of December 31, of year 1. On July 31 of year 2, DP sells 250 of its shares of stock in FC to domestic corporation DT at a price of \$350 per share. DT satisfies the requirements of paragraph (d) of §1.959-1 so as to qualify as DP's successor in interest. On September 30 of year 2, the earnings and profits attributable to the 100,000u included in DP's gross income under section 951(a) for year 1 are distributed to FC which incurs a withholding tax of 10,000u on such distribution (10% of 100,000u) and an additional foreign income tax of 33 $\frac{1}{3}$ % or 30,000u by reason of the inclusion of the net distribution of 90,000u (100,000u minus 10,000u) in its taxable income for year 2. On June 30 of year 3, FC distributes the remaining 60,000u of such earnings and profits to DP and DT: DP receives 45,000u ( $750/1,000 \times 60,000$ ) and excludes such amount from gross income under section 959(a) and §1.959-1(c); DT receives 15,000u ( $250/1,000 \times 60,000$ ) and, as DP's successor in interest, excludes such amount from gross income under section 959(a) and §1.959-1(c).

(ii) *Analysis.* As of June 30 of year 3, DP must reduce the adjusted basis of each of its 750 shares of stock in FC to \$200 ( $\$300$  minus  $(\$45,000/750 + \$10,000/1,000 + \$30,000/1,000)$ ); and DT must reduce the basis of each of its 250 shares of stock in FC to \$250 ( $\$350$  minus  $(\$15,000/250 + \$10,000/1,000 + \$30,000/1,000)$ ).

*Example 2. Sale of lower-tier CFC.* (i) *Facts.* Assume the same facts as in *Example 1*, except that in addition, on July 31 of year 2, FC sells its 500 shares of stock in FS to domestic corporation DT2 at a price of \$600 per share. DT2 satisfies the requirements of §1.959-1(b)(5) so as to qualify as DP's successor in interest. On September 30 of year 2, FS distributes 100,000u of earnings and profits to DT2, which earnings and profits are attributable to the 100,000u included in DP's gross income under section 951(a) for year 1. As DP's successor in interest, DT2 excludes the 100,000u it receives from gross income under section 959(a) and §1.959-1(c).

(ii) *Analysis.* As of September 30 of year 2, DT2 must reduce the basis of each of its 500 shares of stock in FS to \$400 ( $\$600$  minus  $(\$100,000/500)$ ).

*Example 3. Section 956 amount.* (i) *Facts.* DP, a United States shareholder, owns all of the 1,000 shares of the one class of stock in FC, which owns all of the 500 shares of the one class of stock in FS. Each share of DP's stock in FC has a basis of \$200. DP, FC, and FS use the calendar year as a taxable year and FC and FS are CFCs throughout the period here involved. FC and FS both use the u as their functional currency. In year 1, FS has 100,000u of subpart F income after

the payment of 50,000u of foreign income taxes. The average exchange rate for year 1 and year 2 is 1u = \$1. For year 1, DP includes 100,000u in gross income under section 951(a) with respect to FS. In accordance with the provisions of §1.959-3(e)(2)(i) and §1.961-1, DP increases the section 959(c)(2) earnings and profits in its earnings and profits account with respect to its FC stock by 100,000u and correspondingly adjusts the basis of each of its 1,000 shares of stock in FC to \$300 ( $\$200 + \$100,000/1,000$ ) as of December 31 of year 1. In year 2, DP has a section 956 amount with respect to its stock in FC of 100,000u.

(ii) *Analysis.* On December 31 of year 2, DP reclassifies 100,000u of section 959(c)(2) earnings and profits as section 959(c)(1) earnings and profits pursuant to §1.959-3(e)(2)(iv). DP's basis in each of its 1,000 shares of stock in FC remains unchanged at \$300 per share.

Par. 8. Section 1.961-3 is added to read as follows:

*§1.961-3 Basis adjustments in stock held by foreign corporation.*

(a) *Where the upper-tier entity is 100% owned by a single United States shareholder—(1) In general.* If a United States shareholder is treated under section 958(a) as owning stock in a CFC (lower-tier CFC) by reason of owning, either directly or pursuant to the application of section 958(a), stock in one or more other CFCs (each an "upper-tier CFC"), any increase to such United States shareholder's basis in stock or other property under §1.961-1 of this section resulting from an adjustment to such United States shareholder's previously taxed earnings and profits account with respect to its stock in the lower-tier CFC shall also be made to each upper-tier CFC's basis in either the stock in the lower-tier CFC or the property by reason of which it is considered to own stock in the lower-tier CFC under section 958(a), but only for purposes of determining the amount included under section 951 in the gross income of such United States shareholder or its successor in interest. In addition, any downward adjustment to such United States shareholder's (or its successor in interest's) previously taxed earnings and profits account with respect to its stock in a distributor under §1.959-3(e)(3) shall result in a corresponding reduction of the basis of the distributee's stock in the distributor for purposes of determining the amount included in such United States shareholder's gross income under section 951(a).

(2) *Examples.* The application of this paragraph (a) is illustrated by the following examples:

*Example 1. Incorporate dividend from lower-tier CFC to upper-tier CFC.* (i) *Facts.* DP, a United States shareholder, owns all of the stock in FC, a CFC, and FC owns all of the stock in FS, a CFC. DP, FC and FS all use the calendar year as their taxable year and FC and FS both use the U.S. dollar as their functional currency. In year 1, FS has \$100x of subpart F income that is included in DP's gross income under section 951(a)(1). In year 2, FS pays a dividend of \$100x to FC.

(ii) *Analysis.* On December 31 of year 1, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FS are increased by \$100x pursuant to §1.959-3(e)(2)(i) to reflect the inclusion of \$100x in DP's gross income under section 951(a)(1)(A). DP's basis in its stock in FC is correspondingly increased by \$100x pursuant to §1.961-1(b). FC's basis in its stock in FS is also increased by \$100x pursuant to paragraph (a) of this section, but only for purposes of determining the amount included in DP's gross income under section 951. At the end of year 2, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FS are decreased by \$100x and its previously taxed earnings and profits account with respect to its stock in FC are increased by \$100x pursuant to §1.959-3(e)(3) to reflect the transfer of the previously taxed earnings and profits from FS to FC. The \$100x distribution is excluded from FC's income for purposes of determining the amount included in DP's gross income pursuant to §1.959-2(a). FC's basis in its stock in FS, for purposes of determining the amount included in DP's gross income under section 951, is decreased by \$100x pursuant to paragraph (a) of this section.

*Example 2. Sale of upper-tier CFC stock.* (i) *Facts.* DP, a United States shareholder, owns all of the stock in FC, a CFC. FC owns all of the stock in FS1, a CFC, and FS1 owns all of the stock in FS2, a CFC. DP, FC, FS1, and FS2 all use the calendar year as their taxable year and FC, FS1 and FS2 all use the U.S. dollar as their functional currency. In year 1, FS2 has \$100x of subpart F income which is included in DP's gross income under section 951(a)(1)(A). In year 2, FC sells FS1 to FT, a nonresident alien, and recognizes \$100x of gain on the sale.

(ii) *Analysis.* On December 31 of year 1, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FS2 are increased by \$100x pursuant to §1.959-3(e)(2)(i) to reflect the inclusion of \$100x in DP's gross income under section 951(a)(1). DP's basis in its stock in FC is correspondingly increased by \$100x under §1.961-1(b). FC's basis in its stock in FS1 and FS1's basis in its stock in FS2 are also each increased by \$100x under paragraph (a) of this section, but only for purposes of determining the amount included in the gross income of DP under section 951. In year 2, the \$100x of gain on FC's sale of FS1 stock would be subpart F income that would be includible in DP gross income under section 951(a)(1)(A). However, since FC has an additional \$100x of basis in its stock in FS1 for purposes of determining the amount included in DP's gross income under section 951, the



sale of FS1 by FC does not generate any subpart F income to DP.

(b) *Exception where the upper-tier entity is less than 100 percent owned by a single United States shareholder—(1) In general.* If United States shareholders are treated, under section 958(a), as owning stock in a CFC (lower-tier CFC) by reason of owning, either directly or pursuant to the application of section 958(a), stock in one or more other CFCs (each an “upper-tier CFC”), and if, in the aggregate, the lower-tier CFC is less than wholly indirectly owned by a single United States shareholder, any increase to any United States shareholder’s basis in stock or other property under §1.961–1(b) of this section resulting from an increase to such United States shareholder’s previously taxed earnings and profits account with respect to its stock in such lower-tier CFC shall result in an increase to each upper-tier CFC’s basis in either the stock in the lower-tier CFC or the property by reason of which such upper-tier CFC is considered to own stock in the lower-tier CFC under section 958(a), but only for purposes of determining the amount included under section 951 in the gross income of such United States shareholder or its successor in interest. The amount of the increase to each upper-tier CFC’s basis in either the stock in the lower-tier CFC or the property by reason of which such upper-tier CFC is considered to own stock in the lower-tier CFC under section 958(a) shall be equal to the amount that would be excluded from the gross income of such upper-tier CFC pursuant to section 959(b) and §1.959–2(a) if the amount that gave rise to the adjustment to the United States shareholder’s previously taxed earnings and profits account with respect to its stock in the lower-tier CFC were actually distributed through a chain of ownership to such upper-tier CFC. In addition, any decrease to such United States shareholder’s (or successor in interest’s) previously taxed earnings and profits account with respect to its stock in a distributor under §1.959–3(e)(3) shall result in a corresponding reduction of the basis of the distributee’s stock in the distributor. The reduction of the basis of the distributee’s stock in the distributor shall be equal to the amount that would be excluded from the gross income of the

distributee pursuant to section 959(b) and §1.959–2(a).

(2) *Example.* The application of this paragraph (b) is illustrated by the following example:

*Example. Less than wholly owned CFC.* (i) *Facts.* DP, a United States shareholder, owns 70%, and FP, a nonresident alien, owns 30% of the stock in FC, a CFC. FC in turn owns 100% of the stock in FS, a CFC. Each of DP, FC, FN and FS use the calendar year as their taxable year and both FC and FS use the U.S. dollar as their functional currency. Entering year 1, DP has a basis of \$50x in FC and FC has a basis of \$50x in FS. In year 1, FS earns \$100x of subpart F income. In year 2, FC sells FS for \$150x.

(ii) *Analysis.* On December 31 of year 1, DP includes \$70x of the \$100x of subpart F income earned by FS in gross income under section 951(a)(1)(A). DP increases its section 959(c)(2) earnings and profits in its earnings and profits account with respect to its stock in FS by \$70x pursuant to §1.959–3(e)(2)(i). DP increases its basis in FC from \$50x to \$120x pursuant to §1.961–1(b). FC increases its basis in FS from \$50x to \$150x pursuant to paragraph (b)(1) of this section (but only for purposes of determining FC’s subpart F income with respect to DP) because if the \$100x amount of subpart F income of FS that caused the \$70x increase to DP’s previously taxed earnings and profits account with respect to its stock in FS had been distributed to FC, the entire \$100x would be excluded from FC’s gross income pursuant to section 959(b) and §1.959–2(a) for purposes of determining DP’s inclusion under section 951(a)(1)(A). In year 2, when FC sells FS, for purposes of determining DP’s subpart F inclusion, FC is treated as recognizing \$0 on the sale (\$150x sale proceeds - \$150x basis). Therefore, DP includes \$0 in income under section 951(a)(1)(A) as a result of the sale. Although the sale does not generate gain for purposes of determining DP’s subpart F inclusion, it does cause FC’s non-previously taxed earnings and profits to be increased by \$100x (\$150x sale proceeds - \$50x basis).

(c) *Translation rules.* Rules similar to those provided in §1.961–1(c)(3) and §1.961–2(b)(3) shall apply for purposes of determining the exchange rates used to reflect any change to the basis of stock or other property under this section.

Par. 9. Section 1.961–4 is added to read as follows:

**§1.961–4 Section 304 transactions.**

(a) *Deemed redemption treated as a distribution—(1) In general.* In the case of a stock acquisition described in section 304(a)(1) that is treated as a distribution of earnings and profits of a foreign acquiring corporation or a foreign issuing corporation or both, basis adjustments shall be made in accordance with the rules of §§1.961–1, 1.961–2, and 1.961–3.

(2) *Examples.* The application of this section is illustrated by the following examples:

*Example 1. Cross-chain acquisition of first-tier CFC.* (i) *Facts.* DP, a domestic corporation, owns all of the stock in DS, a domestic corporation, and F1, a CFC. DS owns all of the stock in F2, a CFC. DP, DS, F1 and F2 all use the calendar year as their taxable year and F1 and F2 use the U.S. dollar as their functional currency. During year 1, F1 purchases all of the stock in F2 from DS for \$80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of F2’s stock, DP has a previously taxed earnings and profits account consisting of \$20x of section 959(c)(2) earnings and profits with respect to its stock in F1, and F1 has section 959(c)(2) earnings and profits of \$20x and non-previously taxed earnings and profits of \$10x. At the end of year 1, before taking into account the purchase of F2’s stock, DS has a previously taxed earnings and profits account consisting of \$50x of section 959(c)(2) earnings and profits with respect to its stock in F2 and F2 has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$0. Before taking into account the purchase of F2’s stock, DP’s basis in F1’s stock is \$30x and DS’s basis in F2’s stock is \$60x.

(ii) *Analysis.* Under section 304(a)(1), DS is deemed to have transferred the F2 stock to F1 in exchange for F1 stock in a transaction to which section 351(a) applies, and F1 is treated as having redeemed, for \$80x, the F1 stock hypothetically issued to DS. The payment of \$80x is treated as a distribution to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend is made as if the distribution were made, first, by F1 to the extent of its earnings and profits (\$30x), and then by F2 to the extent of its earnings and profits (\$50x). Before taking into account the deemed distributions, DS had a previously taxed earnings and profits account of \$50x with respect to its stock in F2, and DP had a previously taxed earnings and profits account of \$20x with respect to its stock in F1. Under §1.959–3(h)(4)(i), DS is deemed to have a previously taxed earnings and profits account with respect to stock in F1. Under §1.959–3(g)(1), the section 959(c)(2) earnings and profits in DP’s previously taxed earnings and profits account with respect to F1 stock are reduced from \$20x to \$0. As a result, DP’s basis in F1’s stock is reduced from \$30x to \$10x under §1.961–2(a). The deemed distribution of earnings and profits by F2 causes the section 959(c)(2) earnings and profits in DS’s previously taxed earnings and profits account with respect to F2 stock to be reduced from \$50x to \$0. Under §1.961–2(a) and §1.961–3(a), F1’s basis in its newly acquired F2’s stock is reduced from \$60x to \$10x. F1 has a transferred basis of \$10x in F2’s stock.

*Example 2. Cross-chain acquisition of lower-tier CFC.* (i) *Facts.* DP, a domestic corporation, owns all of the stock in two CFCs, FX and FY. FX owns all of the stock in FZ, a CFC. FX, FY and FZ use the U.S. dollar as their functional currency. During year 1, FY purchases all of the stock in FZ from FX for \$80x in a transaction described in section 304(a)(1). On December 31 of year 1, before taking into account the purchase of FZ’s stock, FY has section 959(c)(2) earnings and profits of \$20x and non-previously taxed earnings and profits of \$10x, and FZ

has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$0. Before taking into account FX's purchase of FZ's stock, DP's basis in FX's stock is \$60x; DP's basis in FY's stock is \$30x; and FX's basis in FZ's stock, for purposes of determining the amount includible in DP's gross income under section 951(a), is \$60x.

(ii) *Analysis.* Under section 304(a)(1), FX is deemed to have transferred the FZ stock to FY in exchange for FY stock in a transaction to which section 351(a) applies, and FY is treated as having redeemed, for \$80x, the FY stock hypothetically issued to FX. The payment of \$80x is treated as a distribution of property to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend is made as if the distribution were made, first, by FY to the extent of its earnings and profits, \$30x, and then by FX to the extent of its earnings and profits, \$50x. Under §1.959-2(b), FX is deemed to receive the distributions from FY and FZ through a chain of ownership described in section 958(a), and \$70x is excluded from FX's gross income under section 959(b) and §1.959-2(a). Under §1.959-3(e)(3), the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account for the stock in FY are reduced from \$20x to \$0; the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account for the stock in FZ are reduced from \$50x to \$0; and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account for the stock in FX are increased from \$0 to \$70x (and such account is further increased to \$80x due to the inclusion of \$10x of subpart F income in DP's gross income under section 951(a)). Under §1.961-2(a), DP's basis in the stock in FY is reduced from \$30x to \$10x. DP's basis in the stock in FX is first reduced by \$50x under §1.961-2(a), and then increased by \$80x under §1.961-1(b), for a net increase of \$30x, to \$90x. Under §1.961-3(a), FY's basis in the stock in FZ, for purposes of determining the amount includible in DP's gross income under section 951(a), is reduced by \$50x to \$10x.

Par. 10. Section 1.1502-12 as amended by adding paragraph (s) to read as follows:

*§1.1502-12 Separate taxable income.*

\* \* \* \* \*

(s) The exclusion from gross income of previously taxed earnings and profits shall be determined by the rules of §1.959-3(g).

Par. 11. In section 1.1502-32, add a sentence after the second sentence in paragraph (b)(3)(ii)(D), add a sentence after the fourth sentence in paragraph (b)(3)(iii)(B) and add *Example 11* in paragraph (b)(5)(ii) to read as follows:

*§1.1502-32 Investment adjustments.*

\* \* \* \* \*

- (b) \* \* \*
- (3) \* \* \*
- (ii) \* \* \*

(D) \* \* \* Further, an increase to a member's previously taxed earnings and profits account under §1.959-3(g)(1)(i)(B) that pursuant to section 961(a) and §1.961-1(b) results in an increase to a member's basis in the stock in a CFC shall be treated as the receipt of tax exempt income. \* \* \*

(iii) \* \* \*

(B) \* \* \* Also included as a non-capital, nondeductible expense is a decrease to a member's previously taxed earnings and profits account under §1.959-3(g)(1)(i)(A) that results in a decrease to a member's basis in the stock in a CFC pursuant to section 961(b) and §1.961-2(a). \* \* \*

\* \* \* \* \*

- (5) \* \* \*
- (ii) \* \* \*

*Example 11.* (a) *Facts.* P owns all of the stock of S and S1. S, a United States shareholder, owns 50 percent of the stock in FC, a CFC that uses the U.S. dollar as its functional currency. S1, a United States shareholder owns the remaining 50 percent of the stock in FC. Entering year 1, S has a previously taxed earnings and profits account with respect to its stock in FC consisting of \$50x of section 959(c)(2) earnings and profits and S1 has a previously taxed earnings and profits account with respect to its stock in FC consisting of \$200x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$250x and non-previously taxed earnings and profits of \$100x. In year 1, FC generates no earnings and profits and makes a \$100x distribution of earnings and profits on FC stock held by S and a \$100x distribution of earnings and profits on the FC stock held by S1.

(b) *Analysis.* First, pursuant to §1.959-3(e)(2)(ii), the section 959(c)(2) earnings and profits in S's previously taxed earnings and profits account with respect to its FC stock are decreased from \$50x to \$0 and the section 959(c)(2) earnings and profits in S1's previously taxed earnings and profits account with respect to its FC stock are decreased from \$200x to \$100x. Then, pursuant to §1.959-2(e)(2)(v) and (g)(1)(i)(A), the section 959(c)(2) earnings and profits in S1's previously taxed earnings and profits account with respect to its FC stock are decreased from \$100x to \$50x and, pursuant to §1.959-3(e)(2)(ii)(B) and (g)(1)(i)(B), the section 959(c)(2) earnings and profits in S's previously taxed earnings and profits account with respect to its FC stock are increased from \$0 to \$50x and then decreased from \$50x to \$0. Pursuant to §1.959-1(c) of this section, the entire \$100x distribution to S and \$100x distribution to S1 are excluded from S's and S1's gross incomes. Pursuant to paragraph (b)(3)(ii)(D) of this section, the \$50x increase to the section 959(c)(2) earnings and profits in S's previously taxed earnings and profits account with respect to its FC stock pursuant to §1.959-3(g)(1)(i)(B) is treated as the receipt of \$50x of tax-exempt income by S. Pursuant to paragraph (b)(2)(ii) of this section, P's basis in S's stock is increased by \$50x. Pursuant to paragraph (b)(3)(iii)(B) of this section, the \$50x decrease to the

section 959(c)(2) earnings and profits in S1's previously taxed earnings and profits account with respect to its FC stock pursuant to §1.959-3(g)(1)(i)(A) is treated as a noncapital nondeductible expense to S1. Pursuant to paragraph (b)(2)(iii) of this section, P's basis in S1's stock is decreased by \$50x.

\* \* \* \* \*

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

(Filed by the Office of the Federal Register on August 28, 2006, 8:45 a.m., and published in the issue of the Federal Register for August 29, 2006, 71 F.R. 51155)

## Notice of Proposed Rulemaking and Notice of Public Hearing

### User Fees for Processing Installment Agreements

REG-148576-05

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations relating to user fees for installment agreements. The proposed amendments affect taxpayers who wish to pay their liabilities through installment agreements. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by September 29, 2006. Outlines of topics to be discussed at the public hearing scheduled for October 17, 2006, must be received by September 25, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-148576-05), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, taxpayers may send submissions electronically directly to the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs), or via the Federal e-Rulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-148576-05). The public hearing will be held in the auditorium of the New

Carrollton Federal Building, 5000 Ellin Road, Lanham, MD.

**FOR FURTHER INFORMATION CONTACT:** Concerning submissions and/or to be placed on the building access list to attend the hearing, Kelly Banks, 202-622-7180; concerning cost methodology, Eva Williams, 202-435-5514; concerning the proposed regulations, William Beard, 202-622-3620 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

## **BACKGROUND**

The Independent Offices Appropriations Act (IOAA), which is codified at 31 U.S.C. 9701, authorizes agencies to prescribe regulations that establish charges for services provided by the agency (user fees). The charges must be fair and must be based on the costs to the government, the value of the service to the recipient, the public policy or interest served, and other relevant facts. The IOAA provides that regulations implementing user fees are subject to policies prescribed by the President. Those policies are currently set forth in OMB Circular A-25, 58 FR 38142 (July 15, 1993) (the OMB Circular).

The OMB Circular encourages user fees for government-provided services that confer benefits on identifiable recipients over and above those benefits received by the general public. Under the OMB Circular, an agency that seeks to impose a user fee for government-provided services must calculate its full cost of providing those services. In general, the amount of a user fee should recover the cost of providing the service, unless the Office of Management and Budget (OMB) grants an exception.

Section 6159 authorizes the IRS to enter into an agreement with any taxpayer for the payment of tax in installments. Section 6331(k) generally prohibits the IRS from levying to collect taxes while an installment agreement is in effect. A taxpayer that enters into an installment agreement therefore receives a special benefit of being allowed to pay an outstanding tax obligation over time. Before entering into an installment agreement, the IRS must examine the taxpayer's financial position to determine whether such an agreement is

appropriate. Once the agreement is in effect, the IRS must process the payments and monitor compliance.

Under sections 300.1 and 300.2, the IRS currently charges \$43 for entering into an installment agreement and \$24 for restructuring an installment agreement or reinstating an installment agreement that is in default. The amount of the fees has not changed since the fees were first implemented in 1995. As required by the OMB Circular, the IRS recently completed a review of the installment agreement program and determined that the full cost of an installment agreement is \$105. The IRS also determined that the full cost of restructuring or reinstating an installment agreement is \$45. The higher costs associated with installment agreements result from increases in labor and other costs since 1995 and refinements in the costing model to better account for the full cost of an installment agreement. In accordance with the OMB Circular, these proposed regulations increase the fees to bring them in line with actual costs.

These proposed regulations propose to charge less than full cost for entering into an installment agreement in cases where the taxpayer chooses to pay by way of a direct debit from the taxpayer's bank account. The proposed fee for such an installment agreement is \$52. The reduced fee would only apply to new installment agreements; the charge would still be \$45 for restructuring or reinstating an installment agreement, regardless of the method of payment. While the OMB Circular requires agencies to charge full cost, OMB has granted an exception to the full cost requirement of the OMB Circular for direct debit installment agreements. In addition, the IRS believes that charging less than full cost will encourage taxpayers to choose to pay by direct debit. The IRS has determined that the default rate on direct debit installment agreements is much lower than that for other agreements. These agreements are therefore beneficial both to taxpayers and to tax collection.

## **Proposed Effective Date**

These regulations are proposed to be effective thirty days after the date of publication in the **Federal Register** of the final regulations.

## **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based on the information that follows. The economic impact of these regulations on any small entity would result from the entity being required to pay a fee prescribed by these regulations in order to obtain a particular service. The dollar amount of the fee is not, however, substantial enough to have a significant economic impact on any entity subject to the fee. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## **Comments and Public Hearing**

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

A public hearing has been scheduled for October 17, 2006, at 10:00 a.m. in the auditorium of the New Carrollton Federal Building, 5000 Ellin Rd., Lanham, MD. Due to building security procedures, visitors must enter at the main entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to

present oral comments at the hearing must submit electronic or written comments and an outline of the comments to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Monday, September 25, 2006. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these regulations is William Beard, Office of Associate Chief Counsel (Procedure and Administration), Collection, Bankruptcy and Summons Division.

\* \* \* \* \*

### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 300 is proposed to be amended as follows:

#### PART 300—USER FEES

Paragraph 1. The authority citation for part 300 continues to read as follows:

Authority: 31 U.S.C. 9701.

Par. 2. Section 300.1(b) is amended by adding a sentence to the end of the paragraph to read as follows:

#### §300.1 *Installment agreement fee.*

\* \* \* \* \*

(b) \* \* \* Effective January 1, 2007, the fee for entering into an installment agreement is \$105, except that the fee is \$52 when the taxpayer pays by way of a direct debit from the taxpayer's bank account.

\* \* \* \* \*

Par. 3. Section 300.2(b) is amended by adding a sentence to the end of the paragraph to read as follows:

#### §300.2 *Restructuring or reinstatement of installment agreement fee.*

\* \* \* \* \*

(b) \* \* \* Effective January 1, 2007, the fee for restructuring or reinstating an installment agreement is \$45.

\* \* \* \* \*

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

(Filed by the Office of the Federal Register on August 29, 2006, 8:45 a.m., and published in the issue of the Federal Register for August 30, 2006, 71 F.R. 51538)

## Election of Alternative Funding Schedule

### Announcement 2006–70

This announcement sets forth the procedures for electing an alternative funding schedule for contributions as described in section 402(a)(1) of the Pension Protection Act of 2006 (PPA), Pub. L. No. 109–280.

#### I. Background

Section 402(a)(1) of the PPA permits an eligible plan to elect an alternative funding schedule to apply in lieu of the generally applicable minimum funding requirements. An eligible plan is a defined benefit plan (other than a multiemployer plan) that is sponsored by an employer that is a commercial passenger airline or whose principal business is providing catering services to a commercial passenger airline.

If an election for an alternative funding schedule under section 402(a)(1) of the PPA is made by an employer that sponsors an eligible plan, the election should specify that it will first be effective in a plan year beginning in 2006 or a plan year beginning in 2007. Any such election applies to the plan year for which the election is made and subsequent plan years unless revoked with the consent of the Service. An elec-

tion that first applies the alternative funding schedule for a plan year beginning in 2006 must be made not later than December 31, 2006, and an election that first applies the alternative funding schedule for a plan year beginning in 2007 must be made not later than December 31, 2007. The plan sponsor is permitted to specify a new plan year as part of the alternative funding schedule election, and the change of plan year does not require the approval of the Service.

If an election is made under section 402(a)(1) of the PPA to have an alternative funding schedule apply to an eligible plan for a plan year beginning before January 1, 2008, and if certain other requirements of section 402 of the PPA are satisfied, then, in the case of any applicable plan year (*i.e.*, a plan year for which the alternative funding schedule election is made or a subsequent plan year) beginning before January 1, 2008, the plan will not have an accumulated funding deficiency for purposes of section 302 of the Employee Retirement Income Security Act of 1974 (ERISA) and §§ 412 and 4971 of the Internal Revenue Code (Code) if the contributions for the plan year are not less than the minimum required contribution determined under section 402(e) of the PPA. Similar relief from the minimum funding requirements applies to plan years beginning on or after January 1, 2008, if an alternative funding schedule election is made. In general, under section 402(e) of the PPA, a plan's minimum required contribution is the amount necessary to amortize the plan's unfunded liability over 17 plan years beginning with the first applicable plan year, determined using specified methods and assumptions.

Section II of this announcement sets forth the information that must be contained in the election and the address to which the election must be sent.

#### II. Election of Alternative Funding Schedule under Section 402(a)(1) of the Pension Protection Act of 2006

A. As an officer of the employer maintaining the plan, I hereby elect the alternative funding schedule under section 402(a)(1) of PPA and provide the following information:

1. The employer is:  
\_\_\_\_\_ (a) a commercial passenger airline, or  
\_\_\_\_\_ (b) an entity whose principal business is providing catering services to a commercial passenger airline.
2. The name and EIN of the employer: \_\_\_\_\_
3. The name and plan number of the plan: \_\_\_\_\_
4. Specify the first plan year for which the alternative funding schedule provisions are to apply: \_\_\_\_\_
5. If the plan year is being changed, specify both the old and new plan years:  
\_\_\_\_\_

Signature of employer \_\_\_\_\_ Date \_\_\_\_\_

The election must be signed by an officer of the employer maintaining the plan. An authorized representative of the employer, a plan administrator, or an enrolled actuary may not sign this election on behalf of the employer.

B. This election must be filed at the following address:

Internal Revenue Service  
Commissioner, Tax Exempt and Government Entities Division  
Attention: SE:T:EP:RA:T  
Alternative Funding Schedule Election  
P. O. Box 27063  
McPherson Station  
Washington, D.C. 20038

\_\_\_\_\_

## Revisions to Regulations Relating to Repeal of Tax on Interest of Nonresident Alien Individuals and Foreign Corporations Received From Certain Portfolio Debt Investments; Hearing Cancellation

### Announcement 2006-71

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-118775-06, 2006-28 I.R.B. 73) under sections 871 and 881 of the Internal Revenue Code relating to the exclusion from gross income of portfolio interest paid to a nonresident alien individual or foreign corporation.

DATES: The public hearing, originally scheduled for October 6, 2006, at 10 a.m., is cancelled.

FOR FURTHER INFORMATION CONTACT: Richard A. Hurst of the Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration), at [Richard.A.Hurst@irs.counsel.treas.gov](mailto:Richard.A.Hurst@irs.counsel.treas.gov).

#### SUPPLEMENTARY INFORMATION:

A notice of public hearing that appeared in the **Federal Register** on Wednesday, August 9, 2006, (71 FR 45474), announced that a public hearing was scheduled for October 6, 2006, at 10 a.m., in the IRS Auditorium (New Carrollton Federal Building), 5000 Ellin Road, Lanham, MD 20706. The subject of the public hearing is under sections 871 and 881 of the Internal Revenue Code.

The public comment period for these regulations expired on August 24, 2006. 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

Thursday, August 31, 2006, no one has requested to speak. Therefore, the public hearing scheduled for October 6, 2006, is cancelled.

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

(Filed by the Office of the Federal Register on September 12, 2006, 8:45 a.m., and published in the issue of the Federal Register for September 13, 2006, 71 F.R. 54005)

## Employer Comparable Contributions to Health Savings Accounts Under Section 4980G; Correction

### Announcement 2006-72

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains a correction to final regulations (T.D. 9277, 2006–33 I.R.B. 226) that were published in the **Federal Register** on Monday, July 31, 2006 (71 FR 43056) providing guidance regarding employer comparable contributions to Health Savings Accounts (HSAs) under section 4980G.

DATES: These corrections are effective July 31, 2006.

FOR FURTHER INFORMATION CONTACT: Mireille T. Khoury, (202) 622–6080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

### Background

The correction notice that is the subject of this document is under section 4980G of the Internal Revenue Code.

### Need for Correction

As published, the final regulations (T.D. 9277) contain errors that may prove to be misleading and are in need of clarification.

\* \* \* \* \*

### Correction of Publication

Accordingly, 26 CFR part 54 is corrected by making the following correcting amendments:

### PART 54—PENSION EXCISE TAXES

**Paragraph 1.** The authority citation for part 54 continues to read, in part, as follows:

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

#### §54.4980G–0 [corrected]

**Par. 2.** Section 54.4980G–0 is amended by:

1. Revising the entries for 54.4980G–4 Q–5 and Q–11.

2. Revising the entries for 54.4980G–5 Q–3.

#### §54.4980G–4 *Calculating comparable contributions.*

\* \* \* \* \*

Q–5: Must an employer use the same contribution method as described in Q & A–2 and Q & A–4 of this section for all employees for any month during the calendar year?

\* \* \*

Q–11: If an employer makes additional contributions to the HSAs of all comparable participating employees who are eligible to make the additional contributions (HSA catch-up contributions ) under section 223(b)(3), do the contributions satisfy the comparability rules?

\* \* \* \* \*

#### §54.4980G–5 *HSA comparability rules and cafeteria plans and waiver of excise tax.*

\* \* \* \* \*

Q–3: If under the employer’s cafeteria plan, employees who are eligible individuals and who participate in health assessments, disease management programs or wellness programs receive an employer contribution to an HSA and the employees have the right to elect to make pre-tax salary reduction contributions to their HSAs, are the contributions subject to the comparability rules?

\* \* \* \* \*

**Par. 3.** Section 54.4980G–4 is amended by:

1. Revising A–2 paragraph (c) of *Example 2*.
2. Revising A–2 paragraph (e) of *Example 1*.

#### §54.4980G–4 *Calculating comparable contributions.*

\* \* \* \* \*

A–2: \* \* \*

(c) \* \* \*

*Example 2.* In a calendar year, Employer J offers its employees an HDHP and contributes on a monthly pay-as-you-go basis to the HSAs of employees who are eligible individuals with coverage under Employer J’s HDHP. In the calendar year, Employer J contributes \$50 per month to the HSA of each employee with self-only HDHP coverage and \$100 per month to the HSA of each employee with family HDHP coverage. From January 1<sup>st</sup> through March 31<sup>st</sup> of the calendar year, Employee X is an eligible individual with self-only HDHP coverage. From April 1<sup>st</sup> through December 31<sup>st</sup> of the calendar year, X is an eligible individual with family HDHP coverage. For the months of January, February and March of the calendar year, Employer J contributes \$50 per month to X’s HSA. For the remaining months of the calendar year, Employer J contributes \$100 per month to X’s HSA. Employer J’s contributions to X’s HSA satisfy the comparability rules.

(d) \* \* \*

(e) \* \* \*

*Example 1.* In a calendar year, Employer K offers its employees an HDHP and contributes on a look-back basis to the HSAs of employees who are eligible individuals with coverage under Employer K’s HDHP. Employer K contributes \$600 (\$50 per month) for the calendar year to the HSA of each employee with self-only HDHP coverage and \$1,200 (\$100 per month) for the calendar year to the HSA of each employee with family HDHP coverage. From January 1<sup>st</sup> through June 30<sup>th</sup> of the calendar year, Employee Y is an eligible individual with family HDHP coverage. From July 1<sup>st</sup> through December 31<sup>st</sup>, Y is an eligible individual with self-only HDHP coverage. Employer K contributes \$900 on a look-back basis for the calendar year to Y’s HSA (\$100 per month for the months of January through June and \$50 per month for the months of July through December). Employer K’s contributions to Y’s HSA satisfy the comparability rules.

\* \* \* \* \*

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

(Filed by the Office of the Federal Register on September 12, 2006, 8:45 a.m., and published in the issue of the Federal Register for September 13, 2006, 71 F.R. 53966)

# 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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<sup>1</sup> A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2006–1 through 2006–26 is in Internal Revenue Bulletin 2006–26, dated June 26, 2006.





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