Internal Revenue
bulletin

Bulletin No. 2004-35
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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. 2004–82, page 350.

Low-income housing credit. This ruling answers 12 questions about the low-income housing credit provisions under section 42 of the Code.

Rev. Rul. 2004–91, page 357.

LIFO; price indexes; department stores. The June 2004 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, June 30, 2004.

T.D. 9141, page 359.

Final regulations provide guidance under section 904(d) of the Code, including guidance relating to the exception from passive income for active rents and royalties. The regulations provide guidance under section 904(b) relating to adjustments to the foreign tax credit limitation when a taxpayer has capital gains or losses or qualified dividend income. They provide guidance for individuals who elect under section 904(j) not to apply the foreign tax credit limitation for a particular year. The regulations provide guidance on the allocation of foreign taxes to the separate categories of income under regulations section 1.904–6. Finally, the regulations provide guidance on the exclusion of certain export financing interest from foreign personal holding company income.

REG–124405–03, page 394.

Optional 10-year writeoff of certain tax preferences. Proposed regulations under section 59(e) of the Code provide rules governing the time and manner for making and revoking an election to treat certain qualified expenditures, which are otherwise deductible, as amortized over the applicable period provided for in the statute. The regulations provide that the election may be made for any specific dollar amount of the qualified expenditures, but cannot be made by reference to a formula. To revoke the election, a taxpayer must receive the permission of the Commissioner. Permission will only be granted in rare and unusual circumstances. If permission is granted, the revocation will be effective in the taxpayer's earliest open taxable year affected by the election.

Announcement 2004–64, page 402.

This document withdraws proposed regulations (REG–104683–00, 2001–1 C.B. 407) under section 904(d) of the Code relating to the "look-through" rules for dividends paid by a controlled foreign corporation or a noncontrolled section 902 corporation. It also withdraws proposed regulations under section 902 relating to the computation of a taxpayer's deemed-paid taxes. REG–104683–00 partially withdrawn.

EMPLOYEE PLANS

Notice 2004–56, page 375.

Weighted average interest rate update; corporate bond indices; 30-year Treasury securities. The weighted average interest rate for August 2004 and the resulting permissible range of interest rates used to calculate current liability and to determine the required contribution are set forth.

(Continued on the next page)

Actions Relating to Court Decisions is on the page following the Introduction.
Announcements of Disbarments and Suspensions begin on page 397.
Finding Lists begin on page ii.
Index for July through August begins on page iv.

Department of the Treasury
Internal Revenue Service

Rev. Proc. 2004–56, page 376.

Section 457(b) plan model amendments for governmental plans. This procedure provides model amendments that may be used by a state or local government eligible employer (as defined in section 457(e)(1)(A) of the Code) to amend or draft its eligible section 457(b) plan to reflect the requirements of section 457 and the regulations thereunder. Rev. Proc. 98–41 superseded.

EXEMPT ORGANIZATIONS

Announcement 2004–66, page 402.

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

GIFT TAX

REG–163679–02, page 390.

Proposed regulations under section 2702 of the Code provide guidance in two specific situations relating to qualified interests. The first situation is where the grantor retains an interest payable to the grantor for a term of years, or to the grantor's estate if the grantor dies prior to the expiration of the term. The second situation is where the grantor has a power to revoke a qualified interest of the grantor's spouse. A public hearing is scheduled for October 28, 2004.

EXCISE TAX

Notice 2004–57, page 376.

This notice confirms that the Service will continue to assess and collect tax under section 4251 of the Code on all taxable communications services, including those communications services recently litigated with conflicting results.

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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Actions Relating to Decisions of the Tax Court

It is the policy of the Internal Revenue Service to announce at an early date whether it will follow the holdings in certain cases. An Action on Decision is the document making such an announcement. An Action on Decision will be issued at the discretion of the Service only on unappealed issues decided adverse to the government. Generally, an Action on Decision is issued where its guidance would be helpful to Service personnel working with the same or similar issues. Unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent.

Actions on Decisions shall be relied upon within the Service only as conclusions applying the law to the facts in the particular case at the time the Action on Decision was issued. Caution should be exercised in extending the recommendation of the Action on Decision to similar cases where the facts are different. Moreover, the recommendation in the Action on Decision may be superseded by new legislation, regulations, rulings, cases, or Actions on Decisions.

Prior to 1991, the Service published acquiescence or nonacquiescence only in certain regular Tax Court opinions. The Service has expanded its acquiescence program to include other civil tax cases where guidance is determined to be helpful. Accordingly, the Service now may acquiesce or nonacquiesce in the holdings of memorandum Tax Court opinions, as well as those of the United States District Courts, Claims Court, and Circuit Courts of Appeal. Regardless of the court deciding the case, the recommendation of any Action on Decision will be published in the Internal Revenue Bulletin.

The recommendation in every Action on Decision will be summarized as acquiescence, acquiescence in result only, or nonacquiescence. Both "acquiescence" and "acquiescence in result only" mean that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. However, "acquiescence" indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions; whereas, "acquiescence in result only" indicates disagreement or concern with some or all of those reasons. "Nonacquiescence" signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a "nonacquiescence" indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.

The Actions on Decisions published in the weekly Internal Revenue Bulletin are consolidated semiannually and appear in the first Bulletin for July and the Cumulative Bulletin for the first half of the year. A semiannual consolidation also appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

The Commissioner ACQUIESCES in the following decision:

Kaffenberger v. United States,[1]
314 F.3d 944 (8th Cir. 2003)

The Commissioner ACQUIESCES in result only in the following decision:

Diane Fernandez v. Commissioner,[2]
114 T.C. 324 (2000)
Docket No. 16710–99

The Commissioner does NOT ACQUIESCE in the following decision:

Kaffenberger v. United States,[3]
314 F.3d 944 (8th Cir. 2003)

[1] Acquiescence relating to whether the Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, constitutes an informal claim for refund.

[2] Acquiescence in result only relating to whether the Tax Court has jurisdiction, under I.R.C. section 6015(e) in a case involving an understatement of tax, to review the Service's determination to deny relief under section 6015(f).

[3] Nonacquiescence relating to whether the 2-year period of limitations, set forth in I.R.C. section 6532(a)(1), for bringing a refund suit can be extended once the 2-year period has expired.

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

Section 42.—Low-Income Housing Credit

26 CFR 1.42–5: Monitoring compliance with low-income housing credit requirements.

Questions are answered pertaining to the vacant unit rule, record retention, and tenant income documentation. See Rev. Rul. 2004-82, page 350.

(Also §§ 1.42–5, 1.42–15, 1.103–8.)

Low-income housing credit. This ruling answers 12 questions about the low-income housing credit provisions under section 42 of the Code.

Rev. Rul. 2004–82

PURPOSE

This revenue ruling answers certain questions about the low-income housing credit under § 42 of the Internal Revenue Code.

LAW AND QUESTIONS AND ANSWERS

A. *ELIGIBLE BASIS AND QUALIFIED BASIS ISSUES*

Law

Section 42(a) provides for a credit for investment in certain low-income housing buildings. The amount of the low-income housing credit for any taxable year in the credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building (as defined in § 42(c)(2)).

Section 42(c)(1)(A) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to (i) the applicable fraction (determined as of the close of the taxable year) of (ii) the eligible basis of the building (determined under § 42(d)).

Section 42(c)(1)(B) defines the applicable fraction as the smaller of the unit fraction or the floor space fraction. Section 42(c)(1)(C) defines the unit fraction as the fraction the numerator of which is the number of low-income units (as defined in § 42(i)(3)(A)) in the building and the denominator of which is the number of residential rental units (that is, all units in the building which are available to rent as personal residences), whether or not occupied, in the building. Section 42(c)(1)(D) defines the floor space fraction as the fraction the numerator of which is the total floor space of the low-income units in the building and the denominator of which is the total floor space of the residential rental units, whether or not occupied, in the building.

Section 42(d)(1) provides that the eligible basis of a new building is its adjusted basis as of the close of the first taxable year of the credit period. Section 42(d)(4)(A) provides that, except as provided in § 42(d)(4)(B) and (C), the adjusted basis of any building is determined without regard to the adjusted basis of any property that is not residential rental property. Section 42(d)(4)(B) provides that the adjusted basis of any building includes the adjusted basis of property of a character subject to the allowance for depreciation (1) used in common areas or (2) provided as comparable amenities to all residential rental units in the building.

Section 42(d)(4)(C)(i) provides that the adjusted basis of any building located in a qualified census tract is determined by taking into account the adjusted basis of property (of a character subject to the allowance for depreciation and not otherwise taken into account) used throughout the taxable year in providing any community service facility. Section 42(d)(4)(C)(iii) provides that the term "community service facility" means any facility designed to serve primarily individuals whose income is 60 percent or less of area median income (AMGI) (within the meaning of § 42(g)(1)(B)). Section 42(d)(5)(C)(ii)(I) defines the term "qualified census tract" as any census tract (1) which is designated by the Secretary of Housing and Urban Development (HUD), and (2) for the most recent year for which census data are available on household income in the tract, either in which 50 percent or more of the households have an income which is less than 60 percent of the AMGI for the year or which has a poverty rate of at least 25 percent. See *http://www.huduser.org/datasets/qct.html* for a listing of census tracts designated by the Secretary of HUD.

Section 42(d)(4)(C)(ii) provides that the increase in the adjusted basis of any building which is taken into account because of a community service facility may not exceed 10 percent of the eligible basis of the qualified low-income housing project (as defined in § 42(g)(1)) of which the community service facility is a part. For this purpose, § 42(d)(4)(C)(ii) provides that all community service facilities which are part of the same qualified low-income housing project are treated as one facility.

Rev. Rul. 2003–77, 2003–29 I.R.B. 75, provides that the requirement that a community service facility must be designed to serve primarily individuals whose income is 60 percent or less of AMGI will be satisfied if the following conditions are met. First, the facility must be used to provide services that will improve the quality of life for community residents. Second, the taxpayer must demonstrate that the services provided at the facility will be appropriate and helpful to individuals in the area of the project whose income is 60 percent or less of AMGI. This may, for example, be demonstrated in the market study required to be conducted under § 42(m)(1)(A)(iii), or another similar study. Third, the facility must be located on the same tract of land as one of the buildings that is part of the qualified low-income housing project. Finally, if fees are charged for services provided, they must be affordable to individuals whose income is 60 percent or less of AMGI.

The legislative history of § 42 states that residential rental property for purposes of the low-income housing credit has the same meaning as residential rental property for purposes of § 103. The legislative history of § 42 further states that residential rental property includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–89 (1986), 1986–3 (Vol. 4) C.B. 89.

In the Tax Reform Act of 1986 (the "1986 Act"), Congress reorganized §§ 103 and 103A of the Internal Revenue Code of 1954 (the "1954 Code") regarding tax-exempt bonds into §§ 103 and 141 through 150 of the Internal Revenue Code of 1986. Congress intended that to the extent not amended by the 1986 Act, all principles of pre–1986 Act law would continue to apply to the reorganized provisions. H.R. Conf. Rep. No. 841, 99^{th} Cong., 2d Sess. II–686 (1986), 1986–3 (Vol. 4) C.B. 686. Because no regulations have been promulgated relating to residential rental property for purposes of § 103, the regulations relating to residential rental property promulgated pursuant to the 1954 Code continue to apply except as otherwise modified by the 1986 Act and subsequent law.

Under § 1.103–8(b)(4)(i) of the Income Tax Regulations, facilities that are functionally related and subordinate to residential rental projects are considered residential rental property. Section 1.103–8(b)(4)(iii) provides that functionally related and subordinate facilities include facilities for use by the tenants, such as swimming pools and other recreational facilities, parking areas, and other facilities reasonably required for the project. Examples in § 1.103–8(b)(4)(iii) of facilities reasonably required for a project include units for resident managers or maintenance personnel.

Q–1. A new qualified low-income building (Building) is located in an area in which owners of apartment buildings typically employ security officers due to the level of crime in the area.

(a) If a unit in Building is occupied by a full-time security officer for that building and Building's owner requires the security officer to live in the unit, is the adjusted basis of that unit includable in Building's eligible basis under § 42(d)(1)?

(b) If yes, is that unit a residential rental unit includable in the numerator and denominator of Building's applicable fraction under § 42(c)(1)(B)?

A–1. (a) Yes. The legislative history of § 42 indicates that residential rental property includes, in addition to the residential rental units, facilities for use by the tenants and other facilities reasonably required by the project.

Under § 1.103–8(b)(4)(iii), functionally related and subordinate property is property that is reasonably required for the project. Examples of functionally related and subordinate property are units for resident managers or maintenance personnel. See § 1.103–8(b)(4)(iii). Thus, while units for resident managers or maintenance personnel are not residential rental units, they are treated as part of residential rental property because these units are functionally related and subordinate to the project. The unit occupied by a full-time security officer is similar to the units described in the examples contained in § 1.103–8(b)(4)(iii), and is reasonably required by the project because of the level of crime in the area. Thus, the unit is functionally related and subordinate to Building. As a result, the unit is residential rental property for purposes of § 42 and its adjusted basis is includable in Building's eligible basis under § 42(d)(1).

(b) No. The term "residential rental unit" has a different meaning than the term "residential rental property" for purposes of § 42. Under § 1.103–8(b)(4)(iii), units for resident managers or maintenance personnel are residential rental property because they are functionally related and subordinate to residential rental projects, not because they are residential rental units. Similarly, a unit occupied by a full-time security officer is not a residential rental unit. Only residential rental units are includable in Building's applicable fraction under § 42(c)(1)(B).

If in a later year of the credit period, the unit occupied by the full-time security officer is converted to a residential rental unit, the unit will be includable in the denominator of Building's applicable fraction for that year. If the unit also becomes a low-income unit in a later year, the unit will be includable in the numerator of Building's applicable fraction for that year.

Q–2. A new qualified low-income building (Building) received a housing credit allocation on June 1, 2003, and was placed in service in 2004. Building is located in a qualified census tract (as defined in § 42(d)(5)(C)). The neighborhood in which Building is located is an area with a high rate of crime. In 2004, the local police department leases a unit in Building to be used as a police substation (Facility). The Facility is part of the police department's community outreach program. This Facility is intended to serve as a deterrent to crime in the community, assist the community with solving crime-related problems, reduce the response time to area calls for service, and provide the locally assigned police officers with a local office. The services provided by the police are free of charge. The adjusted basis of the property constituting the Facility (of a character subject to the allowance for depreciation and not otherwise taken into account in the adjusted basis of Building) does not exceed 10 percent of the eligible basis of Building.

As required by § 42(m)(1)(A)(iii), prior to the allocation of low-income housing credit to Building, a comprehensive market study was conducted to assess the housing needs of the low-income individuals in the area to be served by Building. The study found, among other items, that due to the high rate of crime in the community in which Building is located, providing a police substation would be appropriate and helpful to individuals in the area of Building whose income is 60 percent or less of AMGI.

(a) Is the adjusted basis of the Facility includable in Building's eligible basis under § 42(d)(1)?

(b) If yes, is the Facility includable in Building's applicable fraction under § 42(c)(1)(B)?

A–2. (a) Yes. The Facility qualifies as a community service facility under § 42(d)(4)(C)(iii). Under the facts presented, the Facility is designed to serve primarily individuals whose income is 60 percent or less of AMGI for the following reasons: (1) the services provided at the Facility are services that will help improve the quality of life for community residents; (2) the market study required to be conducted under § 42(m)(1)(A)(iii) found that the services provided at the Facility would be appropriate and helpful to individuals in the area of Building whose income is 60 percent or less of AMGI; (3) the Facility is located within Building; and (4) the services provided at the Facility are affordable to individuals whose income is 60 percent or less of AMGI.

Because the other requirements set forth in § 42(d)(4)(C) are met, the adjusted basis of Building will be determined by taking into account the adjusted basis of the Facility. Thus, the adjusted basis of the Facility is includable in Building's eligible basis.

(b) No. The Facility is not a residential rental unit for purposes of § 42. Therefore, the Facility is not includable in either the numerator or denominator of Building's applicable fraction.

Q–3. On applying to the housing credit agency for an allocation of § 42 credits for a new building, the housing credit agency requires that the applicant pay a nonrefundable application fee. If the applicant is successful, an allocation fee is payable to the housing credit agency. Are the application fee and allocation fee includable in the eligible basis of the applicant's low-income housing building?

A–3. No. The application fee and allocation fee are not includable in the eligible basis of the applicant's low-income housing building because the fees are not capitalizable into the adjusted basis of the building. See § 263 and § 263A. However, depending on the facts and circumstances, all or a portion of these fees may be required to be capitalized as amounts paid to create an intangible asset. See § 1.263(a)–4. Any portion of these fees not required to be capitalized under § 1.263(a)–4 may be deductible as an ordinary and necessary expense under § 162 or § 212, provided the taxpayer satisfies the requirements of those sections.

B. *FIRST-YEAR LOW-INCOME UNIT ISSUE*

Law

Section 42(i)(3)(A) defines "low-income unit" as any unit in a building if (i) the unit is rent-restricted (as defined in § 42(g)(2)), and (ii) the individuals occupying the unit meet the income limitation applicable under § 42(g)(1) to the project of which the building is a part (individuals that meet the applicable income limitation are referred to as "income-qualified"). Section 42(i)(3)(B) provides that a unit will not be treated as a low-income unit unless the unit is suitable for occupancy and used other than on a transient basis.

Section 42(f)(1) defines the "credit period" for a low-income housing credit building as the period of 10 taxable years beginning with (A) the taxable year in which the building is placed in service or (B) at the election of the taxpayer, the succeeding taxable year, but in either case only if the building is a qualified low-income building as of the close of the first year of the period.

Section 42(f)(2)(A) provides a special rule for determining the amount of the low-income housing credit allowable for the first year of the credit period. It provides that the credit allowable under § 42(a) with respect to any building for the first taxable year of the credit period must be determined by substituting for the applicable fraction under § 42(c)(1) the fraction (i) the numerator of which is the sum of the applicable fractions determined under § 42(c)(1) as of the close of each full month of the first taxable year of the credit period during which the building was in service, and (ii) the denominator of which is 12.

Q–4. On initial occupancy of a unit in the first year of a newly constructed building's credit period, an income-qualified tenant moved into the unit on the last day of a month. The unit was rent-restricted in accordance with § 42(g)(2). In determining the low-income housing credit for the building for the first year of the credit period, is the unit treated as a low-income unit for that month for purposes of the fraction calculated under § 42(f)(2)(A)?

A–4. Yes. The unit is treated as a low-income unit eligible for inclusion in the numerator and denominator of the monthly applicable fraction calculated under § 42(f)(2)(A)(i) if the tenant, who meets the income limitation under § 42(g)(1), resides in the rent-restricted unit on the last day of the month. However, in accordance with § 42(f)(2)(A), the building must have been placed in service for a full month for the unit to be includable in the numerator and denominator of the monthly applicable fraction.

C. *EXTENDED LOW-INCOME HOUSING COMMITMENT ISSUE*

Law

Section 42(h)(6)(A) provides that no credit will be allowed with respect to any building for the taxable year unless an extended low-income housing commitment (as defined in § 42(h)(6)(B)) is in effect as of the end of the taxable year. Section 42(h)(6)(B)(i) provides that the term "extended low-income housing commitment" means any agreement between the taxpayer and the housing credit agency which requires that the applicable fraction (as defined in § 42(c)(1)) for the building for each taxable year in the extended use period will not be less than the applicable fraction specified in the agreement *and which prohibits the actions described in subclauses (I) and (II) of § 42(h)(6)(E)(ii)*" (emphasis added).

Section 42(h)(6)(E)(ii) provides that the termination of an extended low-income housing commitment under § 42(h)(6)(E)(i) will not be construed to permit before the close of the 3-year period following the termination (I) the eviction or termination of tenancy (other than for good cause) of an existing tenant of any low-income unit, or (II) any increase in the gross rent with respect to a low-income unit not otherwise permitted under § 42.

Section 42(h)(6)(D) defines the term "extended use period" as the period beginning on the first day in the compliance period on which the building is part of a qualified low-income housing project and ending on the later of (1) the date specified by the agency in the extended low-income housing commitment, or (2) the date which is 15 years after the close of the compliance period.

Section 42(h)(6)(J) provides that if, during a taxable year, there is a determination that a valid extended low-income housing commitment was not in effect as of the beginning of the year, the determination will not apply to any period before that year and § 42(h)(6)(A) will be applied without regard to the determination provided that the failure is corrected within 1 year from the date of the determination.

In the Omnibus Budget Reconciliation Act of 1990, 1991–2 C.B. 481, 531 (the "1990 Act"), Congress amended § 42(h)(6)(B)(i) by adding the language emphasized above, which prohibits the actions described in subclauses (I) and (II) of § 42(h)(6)(E)(ii). At the time of this amendment, however, § 42(h)(6)(E)(ii) was already part of § 42.

The legislative history to § 42 states that the extended low-income housing commitment must prohibit the eviction or termination of tenancy (other than for good cause) of an existing tenant of a low-income unit or any increase in the gross rent inconsistent with the rent restrictions on the unit. H. Rep. No. 894, 101st Cong., 2d Sess. 10, 13 (1990).

Q–5. Must the extended low-income housing commitment prohibit the actions described in subclauses (I) and (II) of

§ 42(h)(6)(E)(ii) only for the 3-year period described in § 42(h)(6)(E)(ii)?

A–5. No. Section 42(h)(6)(B)(i) requires that an extended low-income housing commitment include a prohibition during the extended use period against (1) the eviction or the termination of tenancy (other than for good cause) of an existing tenant of any low-income unit (no-cause eviction protection) and (2) any increase in the gross rent with respect to the unit not otherwise permitted under § 42. When Congress amended § 42(h)(6)(B)(i) to add the language emphasized above, § 42(h)(6)(E)(ii) was already part of § 42. As a result, Congress must have intended the amendment to § 42(h)(6)(B)(i) to add an additional requirement beyond what was contained in § 42(h)(6)(E)(ii), which already prohibited the actions described in that section for the 3 years following the termination of the extended use period. Because the requirements of § 42(h)(6)(B)(i) otherwise apply for the extended use period, Congress must have intended the addition of the prohibition against the actions described in subclauses (I) and (II) of § 42(h)(6)(E)(ii) to apply throughout the extended use period.

If it is determined by the end of a taxable year that a taxpayer's extended low-income housing commitment for a building does not meet the requirements for an extended low-income housing commitment under § 42(h)(6)(B) (for example, it does not provide no-cause eviction protection for the tenants of low-income units throughout the extended use period), the low-income housing credit is not allowable with respect to the building for the taxable year, or any prior taxable year. However, if the failure to have a valid extended low-income housing commitment in effect is corrected within 1 year from the date of the determination, the determination will not apply to the current year of the credit period or any prior year.

Pursuant to this revenue ruling, each housing credit agency is required to review its extended low-income housing commitments for compliance with the interpretation of § 42(h)(6)(B)(i) provided in this question and answer. This review must be completed by December 31, 2004. If during the review period the housing credit agency determines that an extended low-income housing commitment is not in compliance with the interpretation of § 42(h)(6)(B)(i) provided in this question and answer, the 1-year period described under § 42(h)(6)(J) will commence on the date of that determination.

D. *HOME INVESTMENT PARTNERSHIP ACT LOAN ISSUES*

Law

Section 42(b)(2)(A) provides that for a qualified low-income building placed in service by the taxpayer after 1987, the term "applicable percentage" means (1) the 70-percent present value credit under § 42(b)(2)(B)(i) for new buildings which are not federally subsidized, and (2) the 30-percent present value credit under § 42(b)(2)(B)(ii) for new buildings which are federally subsidized and for existing buildings.

In general, § 42(d)(5)(C)(i) provides that in the case of any building located in a designated qualified census tract or difficult development area (as defined in § 42(d)(5)(C)(ii) and (iii)), (I) the eligible basis of a new building will be 130 percent of the eligible basis determined without regard to this rule, and (II) in the case of an existing building, the rehabilitation expenditures taken into account under § 42(e) will be 130 percent of the expenditures determined without regard to this rule.

Section 42(g)(1) defines the term "qualified low-income housing project" as any project for residential rental property if the project meets the requirements of § 42(g)(1)(A) or (B), whichever the taxpayer elects. The election is irrevocable. The project meets the requirements of § 42(g)(1)(A) if 20 percent or more of the residential units in the project are rent-restricted and occupied by individuals whose income is 50 percent or less of AMGI. The project meets the requirements of § 42(g)(1)(B) if 40 percent or more of the residential units in the project are rent-restricted and occupied by individuals whose income is 60 percent or less of AMGI. The requirement a taxpayer elects is referred to as the "minimum set-aside" for the project.

Section 42(g)(2)(A) provides that for purposes of § 42(g)(1), a residential unit is rent-restricted if the gross rent with respect to the unit does not exceed 30 percent of the imputed income limitation applicable to the unit.

Section 42(g)(2)(C) provides that the imputed income limitation applicable to a unit is the income limitation which would apply under § 42(g)(1) to individuals occupying the unit if the number of individuals occupying the unit were: (i) in the case of a unit which does not have a separate bedroom, 1 individual; and (ii) in the case of a unit which has one or more separate bedrooms, 1.5 individuals for each separate bedroom.

Section 42(g)(3)(A) provides that a building will be treated as a qualified low-income building only if the project (of which the building is a part) meets the requirements of § 42(g)(1) not later than the close of the first year of the credit period for the building.

Section 42(i)(2)(A) provides that for purposes of § 42(b)(1), a new building will be treated as federally subsidized for any taxable year if, at any time during the taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under § 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or operation thereof.

Section 42(i)(2)(B) provides that a loan or tax-exempt obligation will not be taken into account under § 42(i)(2)(A) if the taxpayer elects to exclude from eligible basis of the building for purposes of § 42(d), in the case of a loan, the principal amount of the loan, and in the case of a tax-exempt obligation, the proceeds of the obligation.

Section 42(i)(2)(C) provides that § 42(i)(2)(A) will not apply to any tax-exempt obligation or below market Federal loan used to provide construction financing for any building if (i) the obligation or loan (when issued or made) identified the building for which the proceeds of the obligation or loan would be used, and (ii) the obligation is redeemed, and the loan is repaid, before the building is placed in service.

Section 42(i)(2)(D) provides that the term "below market Federal loan" means any loan funded in whole or in part with Federal funds if the interest rate payable on the loan is less than the applicable Federal rate (AFR) in effect under § 1274(d)(1) (as of the date the loan was made).

Section 42(i)(2)(E)(i) generally provides that assistance provided under the HOME Investment Partnerships Act (HOME) with respect to any building will not be treated as a below market Federal loan under § 42(i)(2)(D) if 40 percent or more of the residential units in the building are occupied by individuals whose income is 50 percent or less of AMGI (the special set-aside). Section 42(d)(5)(C) (the 130 percent eligible basis increase) does not apply to any building to which the preceding sentence applies.

Q–6. Taxpayer owns a new qualified low-income housing project consisting of Buildings 1 and 2, each containing 100 residential rental units. Forty percent of the units in each building are low-income units. Taxpayer elected the minimum set-aside for the project under § 42(g)(1)(B). Also, Taxpayer elected on Form 8609, *Low-Income Housing Credit Allocation Certification*, to treat the buildings as part of a multiple building project. A HOME loan at less than the AFR was provided with respect to the project.

(a) How does the special set-aside under § 42(i)(2)(E)(i) apply to qualify Buildings 1 and 2 for the 70-percent present value credit under § 42(b)?

(b) What rent restriction applies to the low-income units used to satisfy the special set-aside under § 42(i)(2)(E)(i)?

A–6. (a) To qualify the project for the 70-percent present value credit, Taxpayer must rent at least 40 units in each of Buildings 1 and 2 to tenants whose income is 50 percent or less of AMGI throughout the 15-year compliance period because the rule under § 42(i)(2)(E)(i) applies on a building-by-building basis. Because these units are to be low-income units and Taxpayer elected the minimum set-aside under § 42(g)(1)(B), the same units used to satisfy the special set-aside under § 42(i)(2)(E)(i) will also satisfy the project's minimum set-aside.

(b) The rent restriction that applies for all of the low-income units in the project, including the units in Buildings 1 and 2 which are used to satisfy the special set-aside under § 42(i)(2)(E)(i), is based on the applicable income limitation under § 42(g)(1)(B) because § 42(g)(2)(C) contains no exception for buildings that satisfy the special set-aside contained in § 42(i)(2)(E)(i). Therefore, the imputed income limitation (as defined in § 42(g)(2)(C)) applicable to the units in this project is 60 percent of AMGI. Under § 42(g)(2), rent may not exceed 30 percent of this imputed income limitation.

Q–7. (a) Taxpayer owns a newly constructed qualified low-income housing project consisting of one building located in a qualified census tract (Building). A HOME loan at less than the AFR was provided with respect to Building. Construction of Building was funded in part with an obligation the interest on which is exempt from tax under § 103 that was outstanding after Building was placed in service. Taxpayer did not elect to exclude from eligible basis the principal amount of the HOME loan or the proceeds of the tax-exempt obligation as provided under § 42(i)(2)(B). Forty percent of the residential units in Building are occupied by individuals whose income is 50 percent or less of area median gross income. Is Building eligible for the increase in eligible basis provided under § 42(d)(5)(C)(i)(I)?

(b) The facts are the same as in (a) above except that the interest rate on the HOME loan when made was not less than the AFR in effect under § 1274(d)(1), and the tax-exempt obligation was redeemed before Building was placed in service. Is Building eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I)?

(c) The facts are the same as in (a) above except that the special set-aside under § 42(i)(2)(E)(i) was not met, and the tax-exempt obligation was redeemed before Building was placed in service. Is Building eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I)?

A–7. (a) Yes. Because the tax-exempt obligation is outstanding after Building was placed in service and the proceeds of the obligation were not excluded from Building's eligible basis under § 42(i)(2)(B), Building is treated as federally subsidized under § 42(i)(2)(A). Inasmuch as the building is treated as federally subsidized, the 30-percent present value credit under § 42(b) will apply to Building. The fact that the tax-exempt obligation caused Building to be federally subsidized makes § 42(i)(2)(E)(i) (which provides that certain HOME loans will not cause a project to be federally subsidized if the special set-aside requirement under that section is satisfied, and whose applicability prohibits the increase in eligible basis under § 42(d)(5)(C)) inapplicable. Accordingly, Building is eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I).

If the tax-exempt obligation was redeemed before Building was placed in service or the proceeds of the obligation were excluded from Building's eligible basis, Building would no longer be treated as federally subsidized by the tax-exempt obligation under § 42(i)(2)(A). Therefore, § 42(i)(2)(E)(i) would be applicable, and cause Building not to be treated as federally subsidized by the HOME loan under § 42(i)(2)(A). Accordingly, the prohibition in § 42(i)(2)(E)(i) against using § 42(d)(5)(C) would apply, and Building would not be eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I). The 70-percent value credit under § 42(b) would apply to Building.

(b) Yes. When the HOME loan was made, the interest rate on the loan was not less than the AFR. Therefore, the loan is not described in § 42(i)(2)(D), and the building will not be treated as federally subsidized under § 42(i)(2)(A). The 70-percent present value credit will apply to Building. Because § 42(i)(2)(E)(i) is inapplicable to HOME loans not described in § 42(i)(2)(D), this loan is not subject to § 42(i)(2)(E)(i), and the prohibition in § 42(i)(2)(E)(i) against using § 42(d)(5)(C) does not apply. Accordingly, Building is eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I).

(c) Yes. Although Building meets the exception under § 42(i)(2)(C) with respect to the tax-exempt obligation, Building is treated as federally subsidized under § 42(i)(2)(A) because it received a HOME loan at less than the AFR and does not meet the special set-aside under § 42(i)(2)(E)(i). The 30-percent present value credit will apply to Building as it is treated as federally subsidized. Because Building does not meet the special set-aside under § 42(i)(2)(E)(i), the prohibition in § 42(i)(2)(E)(i) against using § 42(d)(5)(C) does not apply, and Building is eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I).

If Taxpayer elected to exclude the principal amount of the HOME loan from the eligible basis of Building under § 42(i)(2)(B) (whether or not the special set-aside under § 42(i)(2)(E)(i) was met), Building would not be treated as federally subsidized under § 42(i)(2)(A), and the 70-percent present value credit would apply to Building. Because the HOME loan would not be taken into account, § 42(i)(2)(D) and § 42(i)(2)(E)(i) do not apply to Building. Therefore, Building would not be described in § 42(i)(2)(E)(i). Accordingly, the prohibition in § 42(i)(2)(E)(i) against using § 42(d)(5)(C) would not apply, and Building would be eligible for the increase in eligible basis under § 42(d)(5)(C)(i)(I).

E. *VACANT UNIT RULE ISSUES*

Law

Section 1.42–5(c)(1)(ix) provides that a housing credit agency must require the owner of a low-income housing project to certify at least annually to the housing credit agency that, for the preceding 12-month period, if a low-income unit in the project became vacant during the year, reasonable attempts were or are being made to rent that unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project were or will be rented to tenants not having a qualifying income (the "vacant unit rule").

The legislative history to § 42 indicates that vacant units, formerly occupied by low-income individuals, may continue to be treated as occupied by qualified low-income individuals for purposes of the minimum set-aside requirement (as well as for determining qualified basis) provided reasonable attempts are made to rent the unit. H. R. Conf. Rep. No. 841, *supra*, at II–94.

Section 42(g)(2)(D)(i) provides that notwithstanding an increase in the income of the occupants of a low-income unit above the income limitation applicable under § 42(g)(1), the unit will continue to be treated as a low-income unit if the income of the occupants initially met the income limitation and the unit continues to be rent-restricted.

Section 42(g)(2)(D)(ii) provides that if the income of the occupants of the unit increases above 140 percent of the income limitation applicable under § 42(g)(1), the unit ceases to be treated as a low-income unit if any available or subsequently available residential rental unit in the building (of a size comparable to, or smaller than, the unit) is occupied by a new resident whose income exceeds the income limitation (the "available unit rule").

Under § 1.42–15(a), a low-income unit in which the aggregate income of the occupants of the unit rises above 140 percent of the applicable income limitation under § 42(g)(1) is referred to as an "over-income unit."

Section 1.42–15(c) provides that a unit is not available for purposes of the available unit rule when the unit is no longer available for rent due to contractual arrangements that are binding under local law (for example, a unit is not available if it is subject to a preliminary reservation that is binding on the owner under local law prior to the date a lease is signed or the unit is occupied).

Q–8. On July 1, 2003, an income-qualified household (Household) initially occupied a rent-restricted residential rental unit in Building 1 of Project. On October 31, 2003, the property manager moved Household (and transferred Household's lease) to a similar rent-restricted unit in Building 2 of Project that was not previously occupied. Household occupied the Building 2 unit at the end of 2003. The unit Household vacated in Building 1 was unoccupied during November and December. Are both units in Buildings 1 and 2 low-income units at the end of 2003?

A–8. No. While a vacant low-income unit generally retains its character as a low-income unit, where an owner simply moves a tenant from a unit in one building to a unit in another building in the same project, both units may not be treated as low-income units; rather, only the unit that the tenant actually occupies at the end of a month in the first year of the credit period and at the end of each year in subsequent years qualifies as a low-income unit. Thus, in this situation, while the unit in Building 1 vacated by Household was treated as a low-income unit during the months it was occupied by Household, the unit ceased to be treated as a low-income unit when Household vacated the unit. At that time, the vacated unit would be treated as a unit not previously occupied.

Q–9. Ten units previously occupied by income-qualified tenants in a 200-unit mixed-use housing project are vacant. None of the low-income units in the project had been over-income units. The project owner displayed a banner and for rent signs at the entrance to the project, placed classified advertisements in two local newspapers, and contacted prospective low-income tenants on a waiting list for the project and on a local public housing authority list of section 8 voucher holders about the low-income unit vacancies. These are customary methods of advertising apartment vacancies in the area of the project for identifying prospective tenants. Subsequent to the low-income unit vacancies, a market-rate unit of comparable size to the low-income units became vacant. Will the owner violate the vacant unit rule if the owner rents the market-rate unit before any of the low-income units?

A–9. No. In accordance with § 1.42–5 (c)(1)(ix), the owner of a qualified low-income housing project has to use reasonable attempts to rent a vacant low-income unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project are rented to tenants not having a qualifying income. Thus, if the project owner makes reasonable attempts to rent the vacant low-income units to income-qualified tenants, the owner may rent the newly vacated market-rate unit before renting the low-income units and continue to characterize the vacant low-income units as low-income units for purposes of the minimum set-aside requirements in § 42(g)(1) and calculation of the applicable fraction under § 42(c)(1)(B).

What constitutes reasonable attempts to rent a vacant unit is based on facts and circumstances, and may differ from project to project depending on factors such as the size and location of the project, tenant turnover rates, and market conditions. Also, the different advertising methods that are accessible to owners and prospective tenants would affect what is considered reasonable. Under the facts in this situation, the owner used reasonable methods of advertising an apartment vacancy in the area of the project before the owner rented the market-rate unit. Thus, the owner made reasonable attempts to rent the vacant low-income units.

In addition, the available unit rule is not violated by rental of the market-rate unit before the low-income units because there are no over-income units in the building.

Q–10. A building has 10 units of comparable size, consisting of 7 low-income units (none was an over-income unit) and 3 market-rate units. All units in the building were occupied except for one market-rate unit. A low-income unit became vacant on March 15, 2004. Between March 15, 2004, and March 29, 2004, the owner made reasonable attempts to rent this unit to an income-qualified tenant. The vacant low-income unit became subject to a reservation (a contractual arrangement that is binding on the building owner under local law prior to the date a lease is signed or the unit is occupied) on March 29, 2004, under which the owner agreed to rent the unit to *A*, whose income meets the income limitation elected for the project under § 42(g)(1). Thereafter, the owner ceased any efforts to attempt to rent the unit. On April 30, 2004, *A* signed a lease for the unit and occupied the unit on May 1, 2004. The vacant market-rate unit was rented to a market-rate tenant on April 15, 2004. Did the owner violate the vacant unit rule?

A–10. No. For purposes of the vacant unit rule, an owner needs to make reasonable attempts to rent an available vacant low-income unit. To determine what constitutes an available unit for purposes of the vacant unit rule, the Internal Revenue Service will adopt the rule under § 1.42–15(c) for when a unit is considered not available. Therefore, a unit is not available for purposes of the vacant unit rule when the unit is no longer available for rent due to contractual arrangements that are binding under local law, such as a reservation entered into between a building owner and a prospective tenant. Thus, in this situation, because the vacant low-income unit was subject to a reservation that was binding under local law prior to the renting of the vacant market-rate unit, the low-income unit was not available when the market-rate unit was rented. Accordingly, the owner no longer needed to make reasonable efforts to rent the low-income unit.

In addition, the available unit rule is not violated by rental of the market-rate unit because there is no over-income unit in the building.

F. *RECORDKEEPING AND RECORD RETENTION ISSUE*

Law

Section 42(m)(1)(A)(i) requires each housing credit agency to allocate low-income housing credits according to a qualified allocation plan. Under § 42(m)(1)(B)(iii), an allocation plan is not qualified unless it contains a procedure that the housing credit agency (or an agent or other private contractor of the agency) will follow in (1) monitoring for noncompliance with the provisions of § 42, (2) notifying the Service of any noncompliance which the agency becomes aware of, and (3) monitoring for noncompliance with habitability standards through regular site visits.

Under § 1.42–5(a)(2)(i)(A), for the procedure to satisfy § 42(m)(1)(B)(iii), the procedure must include the recordkeeping and record retention provisions of § 1.42–5(b). However, a monitoring procedure adopted by a housing credit agency may require additional recordkeeping and record retention provisions beyond those specifically provided in § 1.42–5(b).

Section 1.42–5(b)(1) provides that a housing credit agency must require the owner of a low-income housing project to keep certain specified records for each qualified low-income building in the project for each year in the compliance period. Under § 1.42–5(b)(2), the owner must be required to retain the records described in § 1.42–5(b)(1) for a particular year for at least 6 years after the due date (with extensions) for filing the Federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the Federal income tax return for the last year of the compliance period (as defined in § 42(i)(1)) of the building. Section 1.42–5(b)(3) also specifies that the owner must be required to retain the original local health, safety, or building code violation reports or notices that were issued by the state or local government unit (as described in § 1.42–5(c)(1)(vi)) for inspection by the housing credit agency.

The general requirements for keeping records for purposes of the Code are in § 6001 and the regulations thereunder.

Rev. Proc. 97–22, 1997–1 C.B. 652, provides guidance to taxpayers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records or transfers their computerized books and records to an electronic storage media, such as an optical disk. Rev. Proc. 97–22 provides that records maintained in an electronic storage system that complies with the requirements of this revenue procedure will constitute records within the meaning of § 6001.

Q–11. May a taxpayer comply with the recordkeeping and record retention provisions under § 1.42–5(b) by using an electronic storage system instead of maintaining hardcopy (paper) books and records?

A–11. Yes, provided that the electronic storage system satisfies the requirements of Rev. Proc. 97–22. However, complying with the recordkeeping and record retention requirements of the Service does not exempt an owner from having to satisfy any additional recordkeeping and record retention requirements of the monitoring procedure adopted by the housing credit agency. For example, the housing credit agency may require the taxpayer to maintain hardcopy books and records.

For the basic requirements of maintaining records in an automated data processing system, including electronic storage systems, see Rev. Proc. 98–25, 1998–1 C.B. 689.

G. *TENANT INCOME DOCUMENTATION ISSUE*

Law

Section 1.42–5(b)(1)(vi) provides that a housing credit agency must require the owner of a low-income housing project to keep records for each qualified low-income building in the project that show, for each year in the compliance period, the annual income certification of each low-income tenant per unit. Under § 1.42–5(b)(1)(vii), the housing credit agency must require the owner to keep documentation to support each low-income tenant's income certification (for example, a copy of the tenant's Federal income tax return, Forms W–2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation).

Under § 1.42–5(c)(1)(iii), the housing credit agency must require the owner of a low-income housing project to certify at least annually that, for the preceding 12-month period, the owner has received an annual income certification from each low-income tenant, and documentation to support that certification.

Rev. Proc. 94–65, 1994–2 C.B. 798, indicates that an owner may satisfy the documentation requirement of § 1.42–5(b)(1)(vii) for a low-income tenant's income from assets by obtaining a signed, sworn statement from the tenant or prospective tenant if (1) the tenant's or prospective tenant's Net Family assets do not exceed $5,000, and (2) the tenant or prospective tenant provides a signed, sworn statement to this effect to the building owner. The revenue procedure provides that a housing credit agency's monitoring procedure may not permit an owner to rely on a low-income tenant's signed, sworn statement of annual income from assets if a reasonable person in the owner's position would conclude that the tenant's income is higher than the tenant's represented annual income. In this case, the owner must obtain other documentation of the low-income tenant's income from assets to satisfy the documentation requirement. In addition, the revenue procedure indicates that a housing credit agency's monitoring procedure may continue to require that an owner obtain documentation, other than the signed, sworn statement, to support a low-income tenant's annual certification of income from assets.

Q–12. On reviewing tenant files of a project, the housing credit agency discovered that for purposes of determining the income of certain tenants, the owner had accepted signed, sworn self-certifications in which the tenants stated that they had not received any child support payments. Is a signed, sworn self-certification by a tenant sufficient documentation under § 1.42–5(b)(1)(vii) to show that the tenant is not receiving child support payments?

A–12. Yes. Consistent with the documentation requirements in Rev. Proc. 94–65, a signed, sworn self-certification by a tenant is sufficient documentation under § 1.42–5(b)(1)(vii) to show that a tenant is not receiving child support payments. In addition to specifying that a tenant is not receiving any child support payments, an annual signed, sworn self-certification should indicate whether the tenant will be seeking or expects to receive child support payments within the next 12 months. If the tenant possesses a child support agreement but is not presently receiving any child support payments, the tenant should include an explanation of this and all supporting documentation such as a divorce decree and court documents to enforce payment. Also, the self-certification should indicate that the tenant will notify the owner of any changes in the status of child support.

A housing credit agency's monitoring procedure, however, may not permit an owner to rely on a low-income tenant's signed, sworn statement indicating that the tenant is not receiving child support payments if a reasonable person in the owner's position would conclude that the tenant's income is higher than the tenant's represented annual income. In this case, the owner must obtain other documentation of the low-income tenant's annual child support payments to satisfy the documentation requirement in § 1.42–5(b)(1)(vii).

A housing credit agency's monitoring procedure may continue to require that an owner obtain documentation, other than the statement described above, to support a low-income tenant's annual certification of child support payments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory N. Doran. For further information regarding this revenue ruling, contact Harold Burghart of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622–3040 (not a toll-free call).

Section 142.—Exempt Facility Bond

26 CFR 1.103–8: Interest on bonds to finance certain exempt facilities.

If the full-time security officer for a § 42 low-income housing project occupies a unit in the project, is that unit functionally related and subordinate property and therefore property that is reasonably required for the project? See Rev. Rul. 2004-82, page 350.

Section 457.—Deferred Compensation Plans of State and Local Governments and Tax-Exempt Organizations

26 CFR 1.457–1: General overviews of section 457.

A revenue procedure provides model amendments that may be used by a State or local government eligible employer (as defined in § 457(e)(1)(A) of the Code) to amend or draft its eligible § 457(b) plan to reflect the requirements of § 457 and the regulations thereunder. See Rev. Proc. 2004-56, page 376.

Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The June 2004 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, June 30, 2004.

Rev. Rul. 2004–91

The following Department Store Inventory Price Indexes for June 2004 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, June 30, 2004.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	June 2003	June 2004	Percent Change from June 2003 to June 2004[1]
1. Piece Goods	464.3	490.9	5.7
2. Domestics and Draperies	557.0	538.7	-3.3
3. Women's and Children's Shoes	629.1	631.8	0.4
4. Men's Shoes	849.5	854.5	0.6
5. Infants' Wear	588.9	567.3	-3.7
6. Women's Underwear	516.1	508.4	-1.5
7. Women's Hosiery	348.9	329.9	-5.4
8. Women's and Girls' Accessories	547.9	581.5	6.1
9. Women's Outerwear and Girls' Wear	362.9	361.9	-0.3
10. Men's Clothing	541.8	540.3	-0.3
11. Men's Furnishings	570.2	578.3	1.4
12. Boys' Clothing and Furnishings	449.6	431.3	-4.1
13. Jewelry	877.8	897.4	2.2
14. Notions	791.4	791.9	0.1
15. Toilet Articles and Drugs	990.0	998.9	0.9
16. Furniture and Bedding	619.9	624.2	0.7
17. Floor Coverings	586.6	592.9	1.1
18. Housewares	726.0	712.6	-1.8
19. Major Appliances	214.1	200.4	-6.4
20. Radio and Television	45.4	41.9	-7.7
21. Recreation and Education[2]	83.1	80.7	-2.9
22. Home Improvements[2]	125.4	129.3	3.1
23. Automotive Accessories[2]	111.5	112.4	0.8
Groups 1–15: Soft Goods	559.5	559.3	0.0
Groups 16–20: Durable Goods	395.6	384.1	-2.9
Groups 21–23: Misc. Goods[2]	94.4	93.4	-1.1
Store Total[3]	500.1	496.5	-0.7

[1]Absence of a minus sign before the percentage change in this column signifies a price increase.

[2]Indexes on a January 1986 = 100 base.

[3]The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7924 (not a toll-free call).

Section 902.—Deemed Paid Credit Where Domestic Corporation Owns 10 Percent or More of Voting Stock of Foreign Corporation

An announcement withdraws proposed regulations relating to the computation of deemed-paid taxes under section 902. See Announcement 2004-64, page 402.

Section 904.—Limitation on Credit

An announcement withdraws proposed regulations relating to the computation of deemed-paid taxes under section 902. See Announcement 2004-64, page 402.

26 CFR 1.904–4: Separate application of section 904 with respect to certain categories of income.

T.D. 9141

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Application of Section 904 to Income Subject to Separate Limitations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the section 904(d) foreign tax credit limitation and to the exclusion of certain export financing interest from foreign personal holding company income. Changes to the applicable law were made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Taxpayer Relief Act of 1997, and the Jobs and Growth Tax Relief Reconciliation Act of 2003. These regulations provide guidance needed to comply with these changes and affect individuals and corporations claiming foreign tax credits and reporting subpart F income.

DATES: *Effective Date:* These regulations are effective July 20, 2004.

Applicability Dates: These regulations generally apply for taxable years beginning on or after July 20, 2004. Section 1.904–4(b)(2)(i) applies with respect to rents and royalties paid or accrued more than 60 days after July 20, 2004. Taxpayers may choose to apply §1.904(b)–1 and §1.904(b)–2 to taxable years ending after July 20, 2004.

FOR FURTHER INFORMATION CONTACT: Bethany A. Ingwalson (202) 622–3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 319) a notice of proposed rulemaking (REG–104683–00, 2001–1 C.B. 407) providing guidance with respect to the application of sections 902 and 904. Several comments were received, and a public hearing was held on April 26, 2001. After consideration of the comments, certain portions of the regulations are withdrawn and the remainder of the regulations are finalized substantially as proposed. The discussion below summarizes the comments received and describes the reasons for withdrawing portions of the proposed regulations and the modifications to the remainder of the regulations. A notice of withdrawal (published as Announcement 2004–64) in this issue of the Bulletin withdraws the proposed amendments to §§1.902–0, 1.902–1 and 1.904–4(g).

Summary of Comments Received and Changes Made

I. Effect of Loss of Domestic Corporate Shareholder on Pooling of Earnings and Taxes in Computing Deemed Paid Credits: §1.902–1

Under the proposed amendments to §1.902–1(a), the multi-year pooling of a foreign corporation's post–1986 undistributed earnings and foreign income taxes would have terminated if the ownership requirements of section 902(c)(3)(B) were not met as of the end of any taxable year, and such earnings and earnings subsequently accumulated in periods during which the stock ownership requirements of section 902 were not met would have been treated as pre–1987 accumulated profits subject to the annual layering rules of section 902(c)(6). Prop. §1.902–1(a)(8), (10) and (13). The proposed amendments also provided for the pooling of earnings and taxes to resume in the first subsequent taxable year as of the end of which the foreign corporation again has a qualifying domestic corporate shareholder. The proposed regulations were intended to alleviate the difficulties of reconstructing accumulated earnings and taxes accounts in connection with a U.S. shareholder's acquisition of stock in a foreign corporation previously owned by U.S. shareholders after an intervening period of foreign ownership.

The Treasury Department and the IRS have determined that the potential simplification benefits of the proposed regulations would be outweighed by other administrative difficulties, including those associated with redeterminations of deemed-paid foreign taxes under section 905(c). Accordingly, the Treasury Department and the IRS are withdrawing the proposed amendments to §1.902–1(a) in a notice of withdrawal published in this issue of the Bulletin.

II. Separate Categories: §1.904–4

A. The active rents and royalties exception

The proposed regulations would have expanded the exception from passive income for active rents and royalties to include rents and royalties received from related payors. The proposed regulations provide that this change would apply to rents and royalties paid or accrued more than 60 days after the date that the final regulations are published in the **Federal Register**. Several comments requested that the amendment to the rents and royalties exception apply retroactively. The Treasury Department and the IRS continue to believe this amendment, which modifies existing final regulations, should apply only prospectively. Therefore, the amendment is adopted without change, and the new final regulations are applicable to rents and royalties paid or accrued more than 60 days after the date that the final regulations are published in the **Federal Register**.

B. Effect of intervening period of noncontrolled or less-than–10%-U.S.-owned status on distributions from a controlled foreign corporation or other look-through corporation

Under section 904(d)(3) and the Treasury regulations thereunder, a U.S. shareholder (as defined in section 951(b)) is allowed look-through treatment for dividends received from a controlled foreign corporation (CFC) if paid out of earnings and profits (E&P) accumulated during periods in which the foreign corporation was a CFC. Section 904(d)(4) allows look-through treatment for dividends paid by a noncontrolled section 902 corporation (10/50 corporation) to a domestic corporation that meets the ownership requirements of section 902(a) from E&P accumulated in a taxable year beginning after December 31, 2002. Section 904(d)(4) provides the Secretary with authority to issue regulations addressing the treatment of dividends paid by a 10/50 corporation out of pre-acquisition E&P.

The proposed regulations would not have provided look-through treatment for a dividend paid by a CFC or 10/50 corporation out of E&P accumulated during a post–2002 period in which the corporation was a CFC or 10/50 corporation if paid after an intervening period during which the corporation was a less-than-10%-U.S.-owned corporation. Prop. §1.904–4(g)(3)(i)(C)(2). Similarly, the proposed regulations would not have provided look-through treatment for a dividend from a CFC out of E&P accumulated during a pre-2003 period in which the corporation was a CFC if paid after an intervening pre-2003 period in which the CFC was a 10/50 corporation or less-than-10%-U.S.-owned corporation. Prop. §1.904–4(g)(3)(i)(C)(1) and (2). The proposed regulations also include a transition year rule that treated E&P accumulated and distributions made during the year in which a CFC or 10/50 corporation loses its look-through status (*i.e.*, becomes a non-CFC for pre-2003 tax years or a less-than-10%-U.S.-owned corporation for post-2002 tax years) as E&P accumulated or distributions made after the loss of look-through status. Prop. §1.904–4(g)(3)(i)(C). The effect of this transition year rule would be to deny look-through treatment for a dividend or an amount treated as a dividend under section 1248(a) from a CFC or 10/50 corporation out of E&P accumulated while the corporation was a look-through entity.

Several comments suggested that the proposed regulations were inconsistent with section 904(d)(2)(E), which provides that a CFC is not treated as a 10/50 corporation with respect to any distribution out of its E&P for periods during which it was a CFC. Comments also criticized the effect of the transition year rule described above. After consideration of the comments, the Treasury Department and the IRS are withdrawing the proposed amendments to §1.904–4(g) in a notice of withdrawal published in this issue of the Bulletin.

C. High-Taxed Income

The final regulations correct an error in an example relating to the grouping of items of income for purposes of determining whether the items are high-taxed income within the meaning of section 904(d)(2)(F).

III. Capital Gain and Loss Adjustments: §1.904(b)–1

A. In General

The proposed regulations under section 904(b) provide guidance concerning the application of the capital gain net income limitation of section 904(b)(2)(A) and 904(b)(2)(B)(i). Prop. §1.904(b)–1(a). The proposed regulations require a taxpayer to reduce foreign source capital gains to the extent the taxpayer's capital gain net income from foreign sources (in the aggregate) exceeded the taxpayer's entire capital gain net income. A taxpayer with a capital gain rate differential for the year and capital gain net income in two or more rate groups within a separate category with capital gain net income would be required to allocate such reduction *pro rata* to each such rate group in the separate category. The proposed regulations do not provide specific guidance concerning short-term capital gains for these purposes. The final regulations clarify that short-term amounts are treated as a rate group for purposes of §1.904(b)–1. Specifically, the final regulations clarify that a taxpayer with capital gain net income from foreign sources in a separate category attributable to capital gain net income in the short-term rate group and in one or more long-term rate groups allocates any reduction pursuant to the capital gain net income limitation *pro rata* to the short-term rate group and each applicable long-term rate group. The final regulations add an example involving short-term capital gain to illustrate this rule.

The proposed regulations also contain a rule limiting net capital gain from foreign sources (in the aggregate) to worldwide net capital gain. Prop. §1.904(b)–1(a). This rule is intended to limit the amount of capital gains from foreign sources (remaining after application of the capital gain net income limitation of section 904(b)(2)(A) and (b)(2)(B)(i)) subject to the rate differential adjustments of section 904(b)(2)(B)(i) and paragraph (c)(1) of the regulations to the extent a taxpayer has a net long-term capital loss from sources within the United States that does not reduce long-term capital gains from foreign sources pursuant to the capital gain net income limitation. This can occur when a taxpayer has short-term capital gains. The final regulations clarify the operation of the net capital gain limitation. In addition, because the net capital gain limitation applies solely for purposes of determining the amount of capital gains from foreign sources subject to the rate differential adjustments of section 904(b)(2)(B)(i) and paragraph (c)(1) of the regulations, the provisions addressing the net capital gain limitation have been moved to paragraph (c)(1) in the final regulations.

B. Election for Certain Noncorporate Taxpayers

The proposed regulations also provide guidance concerning the rate differential adjustments required by section 904(b)(2)(B). Prop. §1.904(b)–1(c) and (d). The final regulations add a rule that permits qualifying noncorporate taxpayers to elect not to apply the rate differential adjustments for any taxable year. Under the final regulations, a noncorporate taxpayer that is not subject to tax under section 55 for the taxable year may elect not to apply the rate differential adjustments if the highest rate of tax imposed on the taxpayer's taxable income (excluding net capital gain and qualified dividend income) for the taxable year under section 1 does not exceed the highest rate of tax in effect under section 1(h) for the taxable year and the amount of the taxpayer's net capital gain from foreign sources, plus the amount of the taxpayer's qualified dividend income from foreign sources, is less than $20,000. Under the tax rates currently in effect, an individual with less than $20,000 of net capital gain and qualified dividend income from foreign sources would be eligible to make the election if the highest rate of tax applicable to such individual's taxable income (excluding net capital gain and qualified dividend income) under section 1 is 28 percent. For example, taxpayers whose filing status is married filing jointly would be eligible to make the election for the 2004 taxable year if their taxable income (excluding net capital gain and qualified dividend income) for 2004 does not exceed $178,650 and the total of their net capital gain and qualified dividend income, from foreign sources, is less than $20,000. A similar election applies to a noncorporate taxpayer subject to the alternative minimum tax for the taxable year. A qualifying taxpayer is presumed to elect out of the rate differential adjustments unless the taxpayer indicates otherwise on its return for the taxable year. The rule is intended to permit taxpayers to avoid the complexity of computing the rate differential adjustments in cases where the failure to make the adjustments does not result in a significant divergence from the results contemplated by section 904(b)(2)(B).

Because capital gains of corporations are not eligible for reduced rates of tax, the eligibility for the election is limited to noncorporate taxpayers.

C. Coordination with Section 904(f)

The proposed regulations contain rules for coordinating the adjustments pursuant to section 904(b)(2) with section 904(f). Prop. §1.904(b)–1(g). The final regulations provide additional guidance concerning the interaction between section 904(b)(2) and (f). First, the final regulations provide that a capital loss from sources within the United States that reduces capital gains from foreign sources pursuant to section 904(b)(2)(A) (or 904(b)(2)(B)(i)) and paragraph (a) of the regulations is disregarded in determining the amount of a taxpayer's taxable income from sources within the United States for purposes of computing the amount of any additions to the taxpayer's overall foreign loss accounts. This rule is intended to prevent the double-counting of capital losses from sources within the United States. Second, the final regulations provide that a taxpayer's loss from sources in the United States (within the meaning of section 904(f)(5)(D)) is the amount by which the taxpayer's foreign source taxable income (in the aggregate after taking into account adjustments pursuant to section 904(b)(2) and the final regulations) exceeds the taxpayer's entire taxable income (after taking into account adjustments pursuant to section 904(b)(2)(B) and the final regulations). The rule is intended to prevent distortions to the foreign tax credit limitation fraction that would otherwise result when a taxpayer has capital gains or losses from sources within the United States. The final regulations add examples to illustrate the operation of these coordination rules.

D. Qualified Dividend Income

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108–27 (117 Stat. 752), extended the capital gain rates under section 1(h) to qualified dividend income of noncorporate taxpayers. JGTRRA provides that rules similar to the rules of section 904(b)(2)(B) (the rate differential adjustment rules) apply with respect to such qualified dividend income. The final regulations implement the coordination rule contained in JGTRRA by requiring a taxpayer to make rate differential adjustments to the taxpayer's qualified dividend income in a manner similar to the adjustments for a taxpayer's capital gains. The final regulations contain an election for noncorporate taxpayers, similar to the election for capital gains and losses, allowing a qualifying taxpayer to elect out of the rate differential adjustments with respect to the taxpayer's qualified dividend income.

Special Analyses

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

Drafting Information

The principal author of these final regulations is Bethany A. Ingwalson of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, other personnel from the IRS and the Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by removing the entries for "1.904–4 through 1.904–7" and the entry for "1.904(b)–3", and by adding entries in numerical order to read, in part, as follows:

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

Section 1.904–4 also issued under 26 U.S.C. 904(d)(6).

Section 1.904(b)–1 also issued under 26 U.S.C. 1(h)(11)(C)(iv) and 904(b)(2)(C).

Section 1.904(b)–2 also issued under 26 U.S.C. 1(h)(11)(C)(iv) and 904(b)(2)(C).

Section 1.904–5 also issued under 26 U.S.C. 904(d)(6).

Section 1.904–6 also issued under 26 U.S.C. 904(d)(6).

Section 1.904–7 also issued under 26 U.S.C. 904(d)(6). * * *

Par. 2. Section 1.904–0 is amended as follows:

1. The entries for §1.904–4 are amended by:

a. Revising the entry for paragraph (b)(2)(iii).

b. Removing the entry for paragraph (b)(2)(iv).

c. Adding an entry for paragraph (m).

2. The entries for §§1.904(b)–1 and 1.904(b)–2 are revised.

3. Removing all the entries for §§1.904(b)–3 and 1.904(b)–4.

4. Adding entries for §1.904(j)–1.

The revisions and additions read as follows:

§1.904–0 Outline of regulation provisions for section 904.

* * * * *

§1.904–4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(b) * * *

(2) * * *

(iii) Example.

* * * * *

(m) Income treated as allocable to an additional separate category.

* * * * *

§1.904(b)–1 Special rules for capital gains and losses.

(a) Capital gains and losses included in taxable income from sources outside the United States.

(1) Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States.

(i) In general.

(ii) Allocation of reduction to separate categories or rate groups.

(A) In general.

(B) Taxpayer with capital gain rate differential.

(2) Exclusivity of rules; no reduction by reason of net capital loss from sources outside the United States in a different separate category.

(3) Capital losses from sources outside the United States in the same separate category.

(4) Examples.

(b) Capital gain rate differential.

(1) Application of adjustments only if capital gain rate differential exists.

(2) Determination of whether capital gain rate differential exists.

(3) Special rule for certain noncorporate taxpayers.

(c) Rate differential adjustment of capital gains.

(1) Rate differential adjustment of capital gains in foreign source taxable income.

(i) In general.

(ii) Special rule for taxpayers with a net long-term capital loss from sources within the United States.

(iii) Examples.

(2) Rate differential adjustment of capital gains in entire taxable income.

(d) Rate differential adjustment of capital losses from sources outside the United States.

(1) In general.

(2) Determination of which capital gains are offset by net capital losses from sources outside the United States.

(e) Qualified dividend income.

(1) In general.

(2) Exception.

(f) Definitions.

(1) Alternative tax rate.

(2) Net capital gain.

(3) Rate differential portion.

(4) Rate group.

(i) Short-term capital gains or losses.

(ii) Long-term capital gains.

(iii) Long-term capital losses.

(5) Terms used in sections 1(h), 904(b) or 1222.

(g) Examples.

(h) Coordination with section 904(f).

(1) In general.

(2) Examples.

(i) Effective date.

§1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.

(a) Application of section 904(b)(2)(B) adjustments.

(b) Use of alternative minimum tax rates.

(1) Taxpayers other than corporations.

(2) Corporate taxpayers.

(c) Effective date.

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§1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.

(a) Election available only if all foreign taxes are creditable foreign taxes.

(b) Coordination with carryover rules.

(1) No carryovers to or from election year.

(2) Carryovers to and from other years determined without regard to election years.

(3) Determination of amount of creditable foreign taxes.

(c) Examples.

(d) Effective date.

Par. 3. Section 1.904–4 is amended as follows:

1. Paragraph (a) is amended by removing the period at the end and adding the language ", or in §1.904–4(m) (additional separate categories)."

2. The first sentence of paragraph (b)(2)(i) is revised.

3. Paragraph (b)(2)(ii) is revised.

4. Paragraph (b)(2)(iii) is removed.

5. Paragraph (b)(2)(iv) is redesignated as paragraph (b)(2)(iii).

6. The last three sentences of the *Example* in newly designated paragraph (b)(2)(iii) are removed and six new sentences are added in their place.

7. The fifth sentence of *Example 4* in paragraph (c)(8) is revised.

8. The language "and" at the end of paragraph (l)(1)(v) is removed.

9. The period at the end of paragraph (l)(1)(vi) is removed and "; and" is added in its place.

10. Paragraph (l)(1)(vii) is added.

11. Paragraph (m) is added.

The revisions and additions read as follows:

§1.904–4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(b) * * *

(2) * * * (i) * * * For rents and royalties paid or accrued after September 18, 2004, passive income does not include any rents or royalties that are derived in the active conduct of a trade or business, regardless of whether such rents or royalties are received from a related or an unrelated person. * * *

(ii) *Exception for certain rents and royalties*. Rents and royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)) of which the recipient is a member. For purposes of this paragraph (b)(2)(ii), an affiliated group includes only domestic corporations and foreign corporations that are controlled foreign corporations in which domestic members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock. For purposes of this paragraph (b)(2)(ii), indirect ownership shall be determined under section 318 and the regulations under that section.

(iii) * * *

Example. * * * Some of the franchisees are unrelated to S and P. Other franchisees are related to S or P and use the licensed property outside of S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations thereunder. The royalty income earned by S with regard to both its related and unrelated franchisees is foreign personal holding company income because S does not satisfy the active trade or business requirements of section 954(c)(2)(A) and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3). However, all of the royalty income earned by S is general limitation income to S under §1.904–4(b)(2)(ii) because P, a member of S's affiliated group (as defined therein), satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). S's royalty income that is taxable to P under subpart F and the royalties paid to P are general limitation income to P under the look-through rules of §1.904–5(c)(1)(i) and (c)(3), respectively.

* * * * *

(c) * * *

(8) * * *

Example 4. * * * The royalty income is not subject to a withholding tax, and is not taxed by Country X, and the interest and the rental income are subject to a 4 percent and 10 percent withholding tax, respectively. * * *

* * *

(l) * * * (1) * * *

(vii) Income that meets the definitions of a separate category described in paragraph (m) of this section and of any other category of separate limitation income described in section 904(d)(1)(A) through (H) will be subject to the separate limitation described in paragraph (m) of this section and will not be treated as general limitation income described in section 904(d)(1)(I).

* * * * *

(m) *Income treated as allocable to an additional separate category*. If section 904(a), (b), and (c) are applied separately to any category of income under the Internal Revenue Code (for example, under section 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), or 904(g)(10)), that category of income will be treated for all purposes of the Internal Revenue Code and regulations as if it were a separate category listed in section 904(d)(1) and (d)(3)(F)(i).

Par. 4. In §1.904–5, paragraph (a)(1) is revised to read as follows:

§1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

(a) * * *

(1) The term *separate category* means, as the context requires, any category of income described in section 904(d)(1)(A), (B), (C), (D), (E), (F), (G), (H), or (I) and in §1.904–4(b), (d), (e), (f), and (g), any category of income described in §1.904–4(m), or any category of earnings and profits to which income described in such provisions is attributable.

* * * * *

Par. 5. In §1.904–6, paragraph (a)(1)(ii) is amended by adding two sentences at the end to read as follows:

§1.904–6 Allocation and apportionment of taxes.

(a) * * * (1) * * *

(ii) * * * If the taxpayer applies the principles of §§1.861–8 through 1.861–14T for purposes of allocating expenses at the level of the taxpayer (or at the level of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes) under this paragraph (a)(1)(ii), such principles shall be applied (for such purposes) in the same manner as the taxpayer applies such principles in determining the income or earnings and profits for United States tax purposes of the taxpayer (or of the qualified business unit, foreign subsidiary, or other entity that paid or accrued the foreign taxes, as the case may be). For example, a taxpayer must use the modified gross income method under §1.861–9T when applying the principles of that section for purposes of this paragraph (a)(1)(ii) to determine the amount of a controlled foreign corporation's income, in each separate category, that is taxed by a foreign country, if the taxpayer applies the modified gross income method under §1.861–9T(f)(3) when applying §1.861–9T to determine the income and earnings and profits of the controlled foreign corporation for United States tax purposes.

* * * * *

Par. 6. Section 1.904(b)–1 is revised to read as follows:

§1.904(b)–1 Special rules for capital gains and losses.

(a) *Capital gains and losses included in taxable income from sources outside the United States*—(1) *Limitation on capital gain from sources outside the United States when the taxpayer has net capital losses from sources within the United States*—(i) *In general*. Except as otherwise provided in this section, for purposes of section 904 and this section, taxable income from sources outside the United States (in all of the taxpayer's separate categories in the aggregate) shall include capital gain net income from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) only to the extent of capital gain net income from all sources. Thus, capital gain net income from sources outside the United States (determined by considering all of the capital gain and loss items in all of the taxpayer's separate categories in the aggregate) shall be reduced to the extent such amount exceeds capital gain net income from all sources.

(ii) *Allocation of reduction to separate categories or rate groups*—(A) *In general*. If capital gain net income from sources outside the United States exceeds capital gain net income from all sources, and the taxpayer has capital gain net income from sources outside the United States in only one separate category, such excess is allocated as a reduction to that separate category. If a taxpayer has capital gain net income from foreign sources in two or more separate categories, such excess must be apportioned on a *pro rata* basis as a reduction to each such separate category. For purposes of the preceding sentence, *pro rata* means based on the relative amounts of the capital gain net income from sources outside the United States in each separate category.

(B) *Taxpayer with capital gain rate differential*. If a taxpayer with a capital gain rate differential for the year (within the meaning of paragraph (b) of this section) has capital gain net income from foreign sources in only one rate group within a separate category, any reduction to such separate category pursuant to paragraph (a)(1)(ii)(A) of this section must be allocated to such rate group. If a taxpayer with a capital gain rate differential for the year (within the meaning of paragraph (b) of this section) has capital gain net income from foreign sources in two or more rate groups within a separate category, any reduction to such separate category pursuant to paragraph (a)(1)(ii)(A) of this section must be apportioned on a *pro rata* basis among such rate groups. For purposes of the preceding sentence, *pro rata* means based on the relative amounts of the capital gain net income from sources outside the United States in each rate group within the applicable separate category.

(2) *Exclusivity of rules; no reduction by reason of net capital losses from sources outside the United States in a different separate category*. Capital gains from sources outside the United States in any separate category shall be limited by reason of section 904(b)(2)(A) and the comparable limitation of section 904(b)(2)(B)(i) only to the extent provided in paragraph (a)(1) of this section (relating to limitation on capital gain from sources outside the United States when taxpayer has net capital losses from sources within the United States).

(3) *Capital losses from sources outside the United States in the same separate category*. Except as otherwise provided in paragraph (d) of this section, taxable income from sources outside the United States in each separate category shall be reduced by any capital loss that is allocable or apportionable to income from sources outside the United States in such separate category to the extent such loss is allowable in determining taxable income for the taxable year.

(4) *Examples*. The following examples illustrate the application of this paragraph (a) to taxpayers that do not have a capital gain rate differential for the taxable year. See paragraph (g) of this section for examples that illustrate the application of this paragraph (a) to taxpayers that have a capital gain rate differential for the year. The examples are as follows:

Example 1. Taxpayer A, a corporation, has a $3,000 capital loss from sources outside the United States in the general limitation category, a $6,000 capital gain from sources outside the United States in the passive category, and a $2000 capital loss from sources within the United States. A's capital gain net income from sources outside the United States in the aggregate, from all separate categories, is $3000 ($6,000 - $3,000). A's capital gain net income from all sources is $1000 ($6000 - $3000 - $2000). Thus, for purposes of section 904, A's taxable income from sources outside the United States in all of A's separate categories in the aggregate includes only $1000 of capital gain net income from sources outside the United States. See paragraph (a)(1)(i) of this section. Pursuant to paragraphs (a)(1)(i) and (a)(1)(ii)(A) of this section, A must reduce the $6000 of capital gain net income from sources outside the United States in the passive category by $2000 ($3000 of capital gain net income from sources outside the United States - $1000 of capital gain net income from all sources). After the adjustment, A has $4000 of capital gain from sources outside the United States in the passive category and $3000 of capital loss from sources outside the United States in the general limitation category.

Example 2. Taxpayer B, a corporation, has a $300 capital gain from sources outside the United States in the general limitation category and a $200 capital gain from sources outside the United States in the passive category. B's capital gain net income from sources outside the United States is $500 ($300 + $200). B also has a $150 capital loss from sources within the United States and a $50 capital gain from sources within the United States. Thus, B's capital gain net income from all sources is $400 ($300 + $200 - $150 + $50). Pursuant to paragraph (a)(1)(ii)(A) of this section, the $100 excess of capital gain net income from sources outside the United States over capital gain net income from all sources ($500 - $400) must be apportioned, as a reduction, three-fifths ($300/$500 of $100, or $60) to the general limitation category and two-fifths ($200/$500 of $100, or $40) to the passive category. Therefore, for purposes of section 904, the general limitation category includes $240 ($300 - $60) of capital gain net income from sources outside the United States and the passive category includes $160 ($200 - $40) of capital gain net income from sources outside the United States.

Example 3. Taxpayer C, a corporation, has a $10,000 capital loss from sources outside the United States in the general limitation category, a $4,000 capital gain from sources outside the United States in the passive category, and a $2,000 capital gain from sources within the United States. C's capital gain net income from sources outside the United States is zero, since losses exceed gains. C's capital gain net income from all sources is also zero. C's capital gain net income from sources outside the United States does not exceed its capital gain net income from all sources, and therefore paragraph (a)(1) of this section does not require any reduction of C's passive category capital gain. For purposes of section 904, C's passive category includes $4,000 of capital gain net income. C's general limitation category includes a capital loss of $6,000 because only $6,000 of capital loss is allowable as a deduction in the current year. The entire $4,000 of capital loss in excess of the $6,000 of capital loss that offsets capital gain in the taxable year is carried back or forward under section 1212(a), and none of such $4,000 is taken into account under section 904(a) or (b) for the current taxable year.

(b) *Capital gain rate differential*—(1) *Application of adjustments only if capital gain rate differential exists*. Section 904(b)(2)(B) and paragraphs (c) and (d) of this section apply only for taxable years in which the taxpayer has a capital gain rate differential.

(2) *Determination of whether capital gain rate differential exists*. For purposes of section 904(b) and this section, a capital gain rate differential is considered to exist for the taxable year only if the taxpayer has taxable income (excluding net capital gain and qualified dividend income) for the taxable year, a net capital gain for the taxable year and—

(i) In the case of a taxpayer other than a corporation, tax is imposed on the net capital gain at a reduced rate under section 1(h) for the taxable year; or

(ii) In the case of a corporation, tax is imposed under section 1201(a) on the taxpayer at a rate less than any rate of tax imposed on the taxpayer by section 11, 511, or 831(a) or (b), whichever applies (determined without regard to the last sentence of section 11(b)(1)), for the taxable year.

(3) *Special rule for certain noncorporate taxpayers*. A taxpayer that has a capital gain rate differential for the taxable year under paragraph (b)(2)(i) of this section and is not subject to alternative minimum tax under section 55 for the taxable year may elect not to apply the rate differential adjustments contained in section 904(b)(2)(B) and paragraphs (c) and (d) of this section if the highest rate of tax imposed on such taxpayer's taxable income (excluding net capital gain and any qualified dividend income) for the taxable year under section 1 does not exceed the highest rate of tax in effect under section 1(h) for the taxable year and the amount of the taxpayer's net capital gain from sources outside the United States, plus the amount of the taxpayer's qualified dividend income from sources outside the United States, is less than $20,000. A taxpayer that has a capital gain rate differential for the taxable year under paragraph (b)(2)(i) of this section and is subject to alternative minimum tax under section 55 for the taxable year may make such election if the rate of tax imposed on such taxpayer's alternative minimum taxable income (excluding net capital gain and any qualified dividend income) under section 55 does not exceed 26 percent, the highest rate of tax imposed on such taxpayer's taxable income (excluding net capital gain and any qualified dividend income) for the taxable year under section 1 does not exceed the highest rate of tax

in effect under section 1(h) for the taxable year and the amount of the taxpayer's net capital gain from sources outside the United States, plus the amount of the taxpayer's qualified dividend income from sources outside the United States, is less than $20,000. A taxpayer who makes this election shall apply paragraph (a) of this section as if such taxpayer does not have a capital gain rate differential for the taxable year. An eligible taxpayer shall be presumed to have elected not to apply the rate differential adjustments, unless such taxpayer applies the rate differential adjustments contained in section 904(b)(2)(B) and paragraphs (c) and (d) of this section in determining its foreign tax credit limitation for the taxable year.

(c) *Rate differential adjustment of capital gains*—(1) *Rate differential adjustment of capital gains in foreign source taxable income*—(i) *In general*. Subject to paragraph (c)(1)(ii) of this section, in determining taxable income from sources outside the United States for purposes of section 904 and this section, capital gain net income from sources outside the United States in each long-term rate group in each separate category (separate category long-term rate group), shall be reduced by the rate differential portion of such capital gain net income. For purposes of paragraph (c)(1) of this section, references to capital gain net income are references to capital gain net income remaining after any reduction to such income pursuant to paragraph (a)(1) of this section (*i.e.*, paragraph (a)(1) of this section applies before paragraphs (c) and (d) of this section).

(ii) *Special rule for taxpayers with a net long-term capital loss from sources within the United States*. If a taxpayer has a net long-term capital loss from sources within the United States (*i.e.*, the taxpayer's long-term capital losses from sources within the United States exceed the taxpayer's long-term capital gains from sources within the United States) and also has any short-term capital gains from sources within or without the United States, then capital gain net income from sources outside the United States in each separate category long-term rate group shall be reduced by the rate differential portion of the applicable rate differential amount. The applicable rate differential amount is determined as follows:

(A) *Step 1*: *Determine the U.S. long-term capital loss adjustment amount*. The U.S. long-term capital loss adjustment amount is the excess, if any, of the net long-term capital loss from sources within the United States over the amount, if any, by which the taxpayer reduced long-term capital gains from sources without the United States pursuant to paragraph (a)(1) of this section.

(B) *Step 2*: *Determine the applicable rate differential amount*. If a taxpayer has capital gain net income from sources outside the United States in only one separate category long-term rate group, the applicable rate differential amount is the excess of such capital gain net income over the U.S. long-term capital loss adjustment amount. If a taxpayer has capital gain net income from sources outside the United States in more than one separate category long-term rate group, the U.S. long-term capital loss adjustment amount shall be apportioned on a *pro rata* basis to each separate category long-term rate group with capital gain net income. For purposes of the preceding sentence, *pro rata* means based on the relative amounts of capital gain net income from sources outside the United States in each separate category long-term rate group. The applicable rate differential amount for each separate category long-term rate group with capital gain net income is the excess of such capital gain net income over the portion of the U.S. long-term capital loss adjustment amount apportioned to the separate category long-term rate group pursuant to this Step 2.

(iii) *Examples*. The following examples illustrate the provisions of paragraph (c)(1)(ii) of this section. The taxpayers in the examples are assumed to have taxable income (excluding net capital gain and qualified dividend income) subject to a rate of tax under section 1 greater than the highest rate of tax in effect under section 1(h) for the applicable taxable year. The examples are as follows:

Example 1. (i) M, an individual, has $300 of long-term capital gain from foreign sources in the passive category, $200 of which is subject to tax at a rate of 15 percent under section 1(h) and $100 of which is subject to tax at a rate of 28% under section 1(h). M has $150 of short-term capital gain from sources within the United States. M has a $100 long-term capital loss from sources within the United States.

(ii) M's capital gain net income from sources outside the United States ($300) does not exceed M's capital gain net income from all sources ($350). Therefore, paragraph (a)(1) of this section does not require any reduction of M's capital gain net income in the passive category.

(iii) Because M has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from U.S. sources ($150), M must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $300 of capital gain net income in the passive category that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $100 ($100 - $0). Under *Step 2*, M must apportion this amount to each rate group in the passive category *pro rata* based on the amount of capital gain net income in each rate group. Thus, $66.67 ($200/$300 of $100) is apportioned to the 15 percent rate group and $33.33 ($100/$300 of $100) is apportioned to the 28 percent rate group. The applicable rate differential amount for the 15 percent rate group is $133.33 ($200 - $66.67). Thus, $133.33 of the $200 of capital gain net income in the 15 percent rate group is subject to a rate differential adjustment pursuant to paragraph (c)(1) of this section. The remaining $66.67 is not subject to a rate differential adjustment. The applicable rate differential amount for the 28 percent rate group is $66.67 ($100 - $33.33). Thus, $66.67 of the $100 of capital gain net income in the 28 percent rate group is subject to a rate differential adjustment pursuant to paragraph (c)(1) of this section. The remaining $33.33 is not subject to a rate differential adjustment.

Example 2. (i) N, an individual, has $300 of long-term capital gain from foreign sources in the passive category, all of which is subject to tax at a rate of 15 percent under section 1(h). N has $50 of short-term capital gain from sources within the United States. N has a $100 long-term capital loss from sources within the United States.

(ii) N's capital gain net income from sources outside the United States ($300) exceeds N's capital gain net income from all sources ($250). Pursuant to paragraph (a)(1) of this section, N must reduce the $300 capital gain in the passive category by $50. N has $250 of capital gain remaining in the passive category.

(iii) Because N has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from U.S. sources ($50), N must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $250 of capital gain in the passive category that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $50 ($100 - $50). Under *Step 2*, the applicable rate differential amount is $200 ($250 - $50). Thus, $200 of the capital gain in the passive category is subject to a rate differential adjustment under paragraph (c)(1) of this section. The remaining $50 is not subject to a rate differential adjustment.

Example 3. (i) O, an individual, has a $100 short-term capital gain from foreign sources in the passive category. O has $300 of long-term capital gain from foreign sources in the passive category, all of which is subject to tax at a rate of 15 percent under section 1(h). O has a $100 long-term capital loss from sources within the United States.

(ii) O's capital gain net income from sources outside the United States ($400) exceeds O's capital gain net income from all sources ($300). Pursuant to paragraph (a)(1) of this section, O must reduce the

$400 capital gain net income in the passive category by $100. Because C has capital gain net income in two or more rate groups in the passive category, O must apportion such amount, as a reduction, to each rate group on a *pro rata* basis pursuant to paragraph (a)(1)(ii)(B) of this section. Thus, $25 ($100/$400 of $100) is apportioned to the short-term capital gain and $75 ($300/$400 of $100) is apportioned to the long-term capital gain in the 15 percent rate group. After application of paragraph (a)(1) of this section, O has $75 of short-term capital gain in the passive category and $225 of long-term capital gain in the 15 percent rate group in the passive category.

(iii) Because O has a net long-term capital loss from sources within the United States ($100) and also has a short-term capital gain from foreign sources ($100), O must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of the $225 of long-term capital gain in the 15 percent rate group that is subject to a rate differential adjustment. Under *Step 1*, the U.S. long-term capital loss adjustment amount is $25 ($100 - $75). Under *Step 2*, the applicable rate differential amount is $200 ($225 - $25). Thus, $200 of the long-term capital gain is subject to a rate differential adjustment under paragraph (c)(1) of this section. The remaining $25 of long-term capital gain is not subject to a rate differential adjustment.

(2) *Rate differential adjustment of capital gains in entire taxable income*. For purposes of section 904 and this section, entire taxable income shall include gains from the sale or exchange of capital assets only to the extent of capital gain net income reduced by the sum of the rate differential portions of each rate group of net capital gain.

(d) *Rate differential adjustment of capital losses from sources outside the United States*—(1) *In general*. In determining taxable income from sources outside the United States for purposes of section 904 and this section, a taxpayer with a net capital loss in a separate category rate group shall reduce such net capital loss by the sum of the rate differential portions of the capital gain net income in each long-term rate group offset by such net capital loss. A net capital loss in a separate category rate group is the amount, if any, by which capital losses in a rate group from sources outside the United States included in a separate category exceed capital gains from sources outside the United States in the same rate group and the same separate category.

(2) *Determination of which capital gains are offset by net capital losses from sources outside the United States*. For purposes of paragraph (d)(1) of this section, in order to determine the capital gain net income offset by net capital losses from sources outside the United States, the following rules shall apply in the following order:

(i) Net capital losses from sources outside the United States in each separate category rate group shall be netted against capital gain net income from sources outside the United States from the same rate group in other separate categories.

(ii) Capital losses from sources within the United States shall be netted against capital gains from sources within the United States in the same rate group.

(iii) Net capital losses from sources outside the United States in excess of the amounts netted against capital gains under paragraph (d)(2)(i) of this section shall be netted against the taxpayer's remaining capital gains from sources within and outside the United States in the following order, and without regard to any net capital losses, from any rate group, from sources within the United States—

(A) First against capital gain net income from sources within the United States in the same rate group;

(B) Next, against capital gain net income in other rate groups, in the order in which capital losses offset capital gains for purposes of determining the taxpayer's taxable income and without regard to whether such capital gain net income derives from sources within or outside the United States, as follows:

(*1*) A net capital loss in the short-term rate group is used first to offset any capital gain net income in the 28 percent rate group, then to offset capital gain net income in the 25 percent rate group, then to offset capital gain net income in the 15 percent rate group, and finally to offset capital gain net income in the 5 percent rate group.

(*2*) A net capital loss in the 28 percent rate group is used first to offset capital gain net income in the 25 percent rate group, then to offset capital gain net income in the 15 percent rate group, and finally to offset capital gain net income in the 5 percent rate group.

(*3*) A net capital loss in the 15 percent rate group is used first to offset capital gain net income in the 5 percent rate group, and then to offset capital gain net income in the 28 percent rate group, and finally to offset capital gain net income in the 25 percent rate group.

(iv) Net capital losses from sources outside the United States in any rate group, to the extent netted against capital gains in any other separate category under paragraph (d)(2)(i) of this section or against capital gains in the same or any other rate group under paragraph (d)(2)(iii) of this section, shall be treated as coming *pro rata* from each separate category that contains a net capital loss from sources outside the United States in that rate group. For example, assume that the taxpayer has $20 of net capital losses in the 15 percent rate group in the passive category and $40 of net capital losses in the 15 percent rate group in the general limitation category, both from sources outside the United States. Further assume that $50 of the total $60 net capital losses from sources outside the United States are netted against capital gain net income in the 28 percent rate group (from other separate categories or from sources within the United States). One-third of the $50 of such capital losses would be treated as coming from the passive category, and two-thirds of such $50 would be treated as coming from the general limitation category.

(v) In determining the capital gain net income offset by a net capital loss from sources outside the United States pursuant to this paragraph (d)(2), a taxpayer shall take into account any reduction to capital gain net income from sources outside the United States pursuant to paragraph (a) of this section and shall disregard any adjustments to such capital gain net income pursuant to paragraph (c)(1) of this section.

(vi) If at any time during a taxable year, tax is imposed under section 1(h) at a rate other than a rate of tax specified in this paragraph (d)(2), the principles of this paragraph (d)(2) shall apply to determine the capital gain net income offset by any net capital loss in a separate category rate group.

(vii) The determination of which capital gains are offset by capital losses from sources outside the United States under this paragraph (d)(2) is made solely in order to determine the appropriate rate-differential-based adjustments to such capital losses under this section and section 904(b), and does not change the source, allocation, or separate category of any such capital gain or loss for purposes of computing taxable income from sources within or outside the United States or for any other purpose.

(e) *Qualified dividend income*—(1) *In general*. A taxpayer that has taxable income (excluding net capital gain and qualified dividend income) for the taxable year and that qualifies for a reduced rate of tax under section 1(h) on its qualified dividend income (as defined in section 1(h)(11)) for the taxable year shall adjust the amount of such qualified dividend income in a manner consistent with the rules of paragraphs (c)(1)(i) (first sentence) and (c)(2) of this section irrespective of whether such taxpayer has a net capital gain for the taxable year. For purposes of making adjustments pursuant to this paragraph (e), the special rule in paragraph (c)(1)(ii) of this section for taxpayers with a net long-term capital loss from sources within the United States shall be disregarded.

(2) *Exception*. A taxpayer that makes the election provided for in paragraph (b)(3) of this section shall not make adjustments pursuant to paragraph (e)(1) of this section. Additionally, a taxpayer other than a corporation that does not have a capital gain rate differential for the taxable year within the meaning of paragraph (b)(2) of this section may elect not to apply paragraph (e)(1) of this section if such taxpayer would have qualified for the election provided for in paragraph (b)(3) of this section had such taxpayer had a capital gain rate differential for the taxable year. Such a taxpayer shall be presumed to make the election provided for in the preceding sentence unless such taxpayer applies the rate differential adjustments provided for in paragraph (e)(1) of this section to the qualified dividend income in determining its foreign tax credit limitation for the taxable year.

(f) *Definitions*. For purposes of section 904(b) and this section, the following definitions apply:

(1) *Alternative tax rate*. The term *alternative tax rate* means, with respect to any rate group, the rate applicable to that rate group under section 1(h) (for taxpayers other than corporations) or section 1201(a) (for corporations). For example, the alternative tax rate for unrecaptured section 1250 gain is 25 percent.

(2) *Net capital gain*. For purposes of this section, net capital gain shall not include any qualified dividend income (as defined in section 1(h)(11)). See paragraph (e) of this section for rules relating to qualified dividend income.

(3) *Rate differential portion*. The term *rate differential portion* with respect to capital gain net income from sources outside the United States in a separate category long-term rate group (or the applicable portion of such amount), net capital gain in a rate group, or capital gain net income in a long-term rate group, as the case may be, means the same proportion of such amount as—

(i) The excess of the highest applicable tax rate (as defined in section 904(b)(3)(E)(ii)) over the alternative tax rate; bears to

(ii) the highest applicable tax rate (as defined in section 904(b)(3)(E)(ii)).

(4) *Rate group*. For purposes of this section, the term *rate group* means:

(i) *Short-term capital gains or losses*. With respect to a short-term capital gain or loss, the rate group is the short-term rate group.

(ii) *Long-term capital gains*. With respect to a long-term capital gain, the rate group is the particular rate of tax to which such gain is subject under section 1(h). Such a rate group is a long-term rate group. For example, the 28 percent rate group of capital gain net income from sources outside the United States consists of the capital gain net income from sources outside the United States that is subject to tax at a rate of 28 percent under section 1(h). Such 28 percent rate group is a long-term rate group. If a taxpayer has long-term capital gains that may be subject to tax at more than one rate under section 1(h) and the taxpayer's net capital gain attributable to such long-term capital gains and any qualified dividend income are taxed at one rate of tax under section 1(h), then all of such long-term capital gains shall be treated as long-term capital gains in that one rate group. If a taxpayer has long-term capital gains that may be subject to tax at more than one rate of tax under section 1(h) and the taxpayer's net capital gain attributable to such long-term capital gains and any qualified dividend income are taxed at more than one rate pursuant to section 1(h), the taxpayer shall determine the rate group for such long-term capital gains from sources within or outside the United States (and, to the extent from sources outside the United States, from each separate category) ratably based on the proportions of net capital gain and any qualified dividend income taxed at each applicable rate. For example, under the section 1(h) rates in effect for tax years beginning in 2004, a long-term capital gain (other than a long-term capital gain described in section 1(h)(4)(A) or (h)(6)) may be subject to tax at 5 percent or 15 percent.

(iii) *Long-term capital losses*. With respect to a long-term capital loss, a loss described in section 1(h)(4)(B)(i) (collectibles loss) or (iii) (long-term capital loss carryover) is a loss in the 28 percent rate group. All other long-term capital losses shall be treated as losses in the highest rate group in effect under section 1(h) for the tax year with respect to long-term capital gains other than long-term capital gains described in section 1(h)(4)(A) or (h)(6). For example, under the section 1(h) rates in effect for tax years beginning in 2004, a long-term capital loss not described in section 1(h)(4)(B)(i) or (iii) shall be treated as a loss in the 15 percent rate group.

(5) *Terms used in sections 1(h), 904(b) or 1222*. For purposes of this section, any term used in this section and also used in section 1(h), section 904(b) or section 1222 shall have the same meaning given such term by section 1(h), 904(b) or 1222, respectively, except as otherwise provided in this section.

(g) *Examples*. The following examples illustrate the provisions of this section. In these examples, the rate differential adjustment is shown as a fraction, the numerator of which is the alternative tax rate percentage and the denominator of which is 35 percent (assumed to be the highest applicable tax rate for individuals under section 1). Finally, all dollar amounts in the examples are abbreviated from amounts in the thousands (for example, $50 represents $50,000). The examples are as follows:

Example 1. (i) AA, an individual, has items from sources outside the United States only in the passive category for the taxable year. AA has $1000 of long-term capital gains from sources outside the United States that are subject to tax at a rate of 15 percent under section 1(h). AA has $700 of long-term capital losses from sources outside the United States, which are not described in section 1(h)(4)(B)(i) or (iii). For the same taxable year, AA has $800 of long-term capital gains from sources within the United States that are taxed at a rate of 28 percent under section 1(h). AA also has $100 of long-term capital losses from sources within the United States, which are not described in section 1(h)(4)(B)(i) or (iii). AA also has $500 of ordinary income from sources within the United States. The highest tax rate in effect under section 1(h) for the taxable year with respect to long-term capital gains other than long-term capital gains described in section 1(h)(4)(A) or (h)(6) is 15 percent. Accordingly, AA's long-term capital losses are in the 15 percent rate group.

(ii) AA's items of ordinary income, capital gain and capital loss for the taxable year are summarized in the following table:

	U.S. source	**foreign source: passive**
15% rate group	($100)	$1,000 ($700)
28% rate group	$800	
Ordinary income	$500	

(iii) AA's capital gain net income from sources outside the United States ($300) does not exceed AA's capital gain net income from all sources ($1,000). Therefore, paragraph (a)(1) of this section does not require any reduction of AA's capital gain net income in the passive category.

(iv) In computing AA's taxable income from sources outside the United States in the numerator of the section 904(a) foreign tax credit limitation fraction for the passive category, AA's $300 of capital gain net income in the 15 rate group in the passive category must be adjusted as required under paragraph (c)(1) of this section. AA adjusts the $300 of capital gain net income using 15 percent as the alternative tax rate, as follows: $300(15%/35%).

(v) In computing AA's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fraction, AA combines the $300 of capital gain net income from sources outside the United States and the $100 net capital loss from sources within the United States in the same rate group (15 percent). AA must adjust the resulting $200 ($300 - $100) of net capital gain in the 15 percent rate group as required under paragraph (c)(2) of this section, using 15 percent as the alternative tax rate, as follows: $200(15%/35%). AA must also adjust the $800 of net capital gain in the 28 percent rate group, using 28 percent as the alternative tax rate, as follows: $800(28%/35%). AA must also include ordinary income from sources outside the United States in the numerator, and ordinary income from all sources in the denominator, of the foreign tax credit limitation fraction.

(vi) AA's passive category foreign tax credit limitation fraction is $128.58/$1225.72, computed as follows:

$$\frac{\$300(15\%/35\%)}{\$500 + \$200(15\%/35\%) + \$800(28\%/35\%)}$$

Example 2. (i) BB, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	**foreign source: general**	**passive**
15% rate group	$300	($500)	$100
25% rate group	$200		
28% rate group	$500	($300)	
Ordinary income	$1,000	$500	$500

(ii) BB's capital gain net income from sources outside the United States in the aggregate (zero, since losses exceed gains) does not exceed BB's capital gain net income from all sources ($300). Therefore, paragraph (a)(1) of this section does not require any reduction of BB's capital gain net income in the passive category.

(iii) In computing BB's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, BB must adjust capital gain net income from sources outside the United States in each separate category long-tem rate group and net capital losses from sources outside the United States in each separate category rate group as provided in paragraphs (c)(1) and (d) of this section.

(A) The $100 of capital gain net income in the 15 percent rate group in the passive category is adjusted under paragraph (c)(1) of this section as follows: $100(15%/35%).

(B) BB must adjust the net capital losses in the 15 percent and 28 percent rate groups in the general limitation category in accordance with the ordering rules contained in paragraph (d)(2) of this section. Under paragraph (d)(2)(i) of this section, BB's net capital loss in the 15 percent rate group is netted against capital gain net income from sources outside the United States in other separate categories in the same rate group. Thus, $100 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $100 of capital gain net income in the 15 percent rate group in the passive category. Accordingly, $100 of the $500 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $100(15%/35%).

(C) Next, under paragraph (d)(2)(iii)(A) of this section, BB's net capital losses from sources outside the United States in any separate category rate group are netted against capital gain net income in the same rate group from sources within the United States. Thus, $300 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $300 of capital gain net income in the 15 percent rate group from sources within the United States. Accordingly, $300 of the $500 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $300(15%/35%). Similarly, the $300 of net capital loss in the 28 percent rate group in the general limitation category offsets $300 of capital gain net income in the 28 percent rate group from sources within the United States. The $300 net capital loss is adjusted under paragraph (d)(1) of this section as follows: $300(28%/35%).

(D) Finally, under paragraph (d)(2)(iii)(B) of this section, the remaining net capital losses in a separate category rate group are netted against capital gain net income from other rate groups from sources within and outside the United States. Thus, the remaining $100 of the $500 net capital loss in the 15 percent rate group in the general limitation category offsets $100 of the remaining capital gain net income in the 28 percent rate group from sources within the United States. Accordingly, the remaining $100 of net capital loss is adjusted under paragraph (d)(1) of this section as follows: $100(28%/35%).

(iv) In computing BB's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, BB must adjust net capital gain by netting all of BB's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate group, under paragraph (c)(2) of this section. BB must also include foreign source ordinary income in the numerators, and ordinary income from all sources in the denominator, of the foreign tax credit limitation fractions. The denominator of BB's foreign tax credit limitation fractions reflects $2,000 of ordinary income from all sources, $100 of net capital gain taxed at the 28% rate and adjusted as follows: $100(28%/35%), and $200 of net capital gain taxed at the 25% rate and adjusted as follows: $200(25%/35%).

(v) BB's foreign tax credit limitation fraction for the general limitation category is $8.56/$2222.86, computed as follows:

$$\frac{\$500 - \$100(15\%/35\%) - \$300(15\%/35\%) - \$300(28\%/35\%) - \$100(28\%/35\%)}{\$1{,}000 + \$500 + \$500 + \$100(28\%/35\%) + \$200(25\%/35\%)}$$

(vi) BB's foreign tax credit limitation fraction for the passive category is $542.86/$2222.86, computed as follows:

$$\frac{\$500 + \$100(15\%/35\%)}{\$1{,}000 + \$500 + \$500 + \$100(28\%/35\%) + \$200(25\%/35\%)}$$

Example 3. (i) CC, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	foreign source: general	foreign source: passive
15% rate group	$300	($720)	($80)
25% rate group	$200		
28% rate group	$500	($150)	$50
Ordinary income	$1,000	$1,000	$500

(ii) CC's capital gain net income from sources outside the United States (zero, since losses exceed gains) does not exceed CC's capital gain net income from all sources ($100). Therefore, paragraph (a)(1) of this section does not require any adjustment.

(iii) In computing CC's taxable income from sources outside the United States in the numerators of the section 904(a) foreign tax credit limitation fractions for the passive and general limitation categories, CC must adjust capital gain net income from sources outside the United States in each separate category long-tem rate group and net capital losses from sources outside the United States in each separate category rate group as provided in paragraphs (c)(1) and (d) of this section.

(A) CC must adjust the $50 of capital gain net income in the 28 percent rate group in the passive category pursuant to paragraph (c)(1) of this section as follows: $50(28%/35%).

(B) Under paragraph (d)(2)(i) of this section, $50 of CC's $150 net capital loss in the 28 percent rate group in the general limitation category offsets $50 of capital gain net income in the 28 percent rate group in the passive category. Thus, $50 of the $150 net capital loss is adjusted as follows: $50(28%/35%). Next, under paragraph (d)(2)(iii)(A) of this section, the remaining $100 of net capital loss in the 28 percent rate group in the general limitation category offsets $100 of capital gain net income in the 28 percent rate group from sources within the United States. Thus, the remaining $100 of net capital loss is adjusted as follows: $100(28%/35%).

(C) Under paragraphs (d)(2)(iii)(A) and (d)(2)(iv) of this section, the net capital losses in the 15 percent rate group in the passive and general limitation categories offset on a *pro rata* basis the $300 of capital gain net income in the 15 percent rate group from sources within the United States. The proportionate amount of the $720 net capital loss ($720/$800 of $300, or $270) is adjusted as follows: $270(15%/35%). The proportionate amount of the $80 net capital loss ($80/$800 of $300, or $30) is adjusted as follows $30(15%/35%).

(D) Of the remaining $500 of net capital loss in the 15 percent rate group in the general limitation and passive categories, $400 offsets the remaining $400 of capital gain net income in the 28 percent rate group from sources within the United States under paragraph (d)(2)(iii)(B)(*3*) of this section. The proportionate amount of the $720 net capital loss ($720/$800 of $400, or $360) is adjusted as follows: $360(28%/35%). The proportionate amount of the $80 net capital loss ($80/$800 of $400, or $40) is adjusted as follows: $40(28%/35%).

(E) Under paragraph (d)(2)(iii)(B)(*3*) of this section, the remaining $100 of net capital loss in the 15 percent rate group in the general limitation and passive limitation categories offsets $100 of capital gain net income in the 25 percent rate group from sources within the United States. The proportionate amount of the $720 net capital loss ($720/$800 of $100, or $90) is adjusted as follows: $90(25%/35%). The proportionate amount of the $80 net capital loss ($80/$800 of $100 of $10) is adjusted as follows: $10(25%/35%).

(iv) In computing CC's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, CC must adjust capital gain net income by netting all of CC's capital gains and losses, from sources within and outside the United States, and adjusting any remaining net capital gains, based on rate group, under paragraph (c)(2) of this section. The denominator of CC's foreign tax credit limitation fractions reflects $2,500 of ordinary income from all sources and $100 of net capital gain taxed at the 25% rate and adjusted as follows: $100(25%/35%).

(v) CC's foreign tax credit limitation fraction for the general limitation category is $424.87/$2571.42, computed as follows:

$$\frac{\$1{,}000 - \$50\ (28\%/35\%) - \$100(28\%/35\%) - \$270(15\%/35\%) - \$360(28\%/35\%) - \$90(25\%/35\%)}{\$1{,}000 + \$1{,}000 + \$500 + \$100(25\%/35\%)}$$

(vi) CC's foreign tax credit limitation fraction for the passive category is $488.00/$2571.42, computed as follows:

$$\frac{\$500 + \$50(28\%/35\%) - \$30(15\%/35\%) - \$40(28\%/35\%) - \$10(25\%/35\%)}{\$1{,}000 + \$1{,}000 + \$500 + \$100(25\%/35\%)}$$

Example 4. (i) DD, an individual, has the following items of ordinary income, capital gain and capital loss for the taxable year:

	U.S. source	foreign source: general	foreign source: passive
15% rate group	($80)	($100)	$300
Short-term		$500	$100
Ordinary income	$500		

(ii) DD's capital gain net income from outside the United States ($800) exceeds DD's capital gain net income from all sources ($720). Pursuant to paragraph (a)(1)(ii)(A) of this section, DD must apportion the $80 of excess of capital gain net income from sources outside the United States between the general limitation and passive categories based on the amount of capital gain net income in each separate category. Thus, one-half ($400/$800 of $100, or $40) is apportioned to the general limitation category and one-half ($400/$800 of $80, or $40) is apportioned to the passive category. The $40 apportioned to the general limitation category reduces DD's $500 short-term capital gain in the general limitation category to $460. Pursuant to paragraph (a)(1)(ii)(B) of this section, the $40 apportioned to the passive category must be apportioned further between the capital gain net income in the short-term rate group and the 15 percent rate group based on the relative amounts of capital gain net income in each rate group. Thus, one-fourth ($100/$400 of $40 or $10) is apportioned to the short-term rate group and three-fourths ($300/$400 of $40 or $30) is apportioned to the 15 percent rate group. DD's passive category includes $90 of short-term capital gain and $270 of capital gain net income in the 15% rate group.

(iii) Because DD has a net long-term capital loss from sources within the United States ($80) and also has short-term capital gains, DD must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of DD's $270 of capital gain net income in the 15% rate group that is subject to a rate differential adjustment under paragraph (c)(1) of this section. Under Step 1, the U.S. long-term capital loss adjustment amount is $50 ($80 - $30). Under Step 2, the applicable rate differential amount is the excess of the remaining capital gain net income over the U.S. long-term adjustment amount. Thus, the applicable rate differential amount is $220 ($270 - $50). In computing DD's taxable income from sources outside the United States in the numerator of the section 904(a) foreign tax credit limitation fraction for the passive category, DD must adjust this amount as follows: $220(15%/35). DD does not adjust the remaining $50 of capital gain net income in the 15% rate group.

(iv) The amount of capital gain net income in the 15% rate group in the passive category, taking into account the adjustment pursuant to paragraph (a)(1) of this section and disregarding the adjustment pursuant to paragraph (c)(1) of this section, is $270. Under paragraphs (d)(2)(i) and (d)(2)(v) of this section, DD's $100 net capital loss in the 15% rate group in the general limitation category offsets capital gain net income in the 15% rate group in the passive category. Accordingly, the $100 of net capital loss is adjusted as follows: $100(15%/35%).

(v) In computing DD's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, DD must adjust capital gain net income by netting all of DD's capital gains and losses from sources within and outside the United States, and adjusting the remaining net capital gain in each rate group pursuant to paragraph (c)(2) of this section. The denominator of DD's foreign tax credit limitation fraction reflects $500 of ordinary income from all sources, $600 of short-term capital gain and $120 of net capital gain in the 15 percent rate group adjusted as follows: $120(15%/35%).

(vi) DD's foreign tax credit limitation fraction for the general limitation category is $417.14/$1151.43, computed as follows:

$$\frac{\$460 - \$100(15\%/35\%)}{\$500 + \$600 + \$120(15\%/35\%)}$$

(vii) DD's foreign tax credit limitation fraction for the passive category is $234.29/$1151.43, computed as follows:

$$\frac{\$90 + \$220(15\%/35\%) + \$50}{\$500 + \$600 + \$120(15\%/35\%)}$$

Example 5. (i) EE, an individual, has the following items of ordinary income, capital gain and capital loss for the taxable year:

	U.S. source	foreign source: passive
15% rate group	($150)	$300
28% rate group		$200
Short-term	$30	$100
Ordinary income	$500	

(ii) EE's capital gain net income from sources outside the United States ($600) exceeds EE's capital gain net income from all sources ($480). Pursuant to paragraph (a)(1)(ii) of this section, the $120 of excess capital gain net income from sources outside the United States is allocated as a reduction to the passive category and must be apportioned *pro rata* to each rate group within the passive category with capital gain net income. Thus, $20 ($100/$600 of $120) is apportioned to the short-term rate group, $60 ($300/$600 of $120) is apportioned to the 15 percent rate group and $40($200/$600 of $120) is apportioned to the 28 percent rate group. After application of paragraph (a)(1) of this section, EE has $80 of capital gain net income in the short-term rate group, $240 of capital gain net income in the 15 percent rate group and $160 of capital gain net income in the 28 percent rate group.

(iii) Because EE has a net long-term capital loss from sources within the United States ($150) and also has short-term capital gains, EE must apply the provisions of paragraph (c)(1)(ii) of this section to determine the amount of EE's remaining $400 ($240 + $160) of capital gain net income in long-term rate groups in the passive category that is subject to a rate differential adjustment. Under Step 1, the U.S. long-term capital loss adjustment amount is $50 ($150 - $100). Under Step 2, EE must apportion this amount *pro rata* to each long-tem rate group within the passive category with capital gain net income. Thus, $30 ($240/$400 of $50) is apportioned to the 15 percent rate group and $20 ($160/$400 of $50) is apportioned to the 28 percent rate group. The applicable rate differential amount for the 15 percent rate group is $210 ($240 - $30). The applicable rate differential amount for the 28 percent rate group is $140 ($160 - $20).

(iv) Pursuant to paragraph (c)(1)(ii) of this section, EE must adjust $210 of the $240 capital gain in the 15 percent rate group as follows: $210 (15%/35%). EE does not adjust the remaining $30. Pursuant to paragraph (c)(1)(ii) of this section, EE must adjust $140 of the $160 capital gain in the 28 percent rate group as follows: $140 (28%/35%). EE does not adjust the remaining $20.

(v) In computing EE's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fractions, EE must adjust capital gain net income by netting all of EE's capital gains and losses from sources within and outside the United States, and adjusting the remaining net capital gain in each rate group pursuant to paragraph (c)(2) of this section. The denominator of EE's foreign tax credit limitation fraction reflects $500 of ordinary income from all sources, $130 of short-term capital gain, $150 of net capital gain in the 15 percent rate group adjusted as follows: $150(15%/35%), and $200 of net capital gain in the 28 percent rate group adjusted as follows: $200(28%/35%).

(vi) EE's foreign tax credit limitation fraction for the passive category is $332/$854.29, computed as follows:

$$\frac{\$80 + \$210\ (15\%/35\%) + \$30 + \$140\ (28\%/35\%) + \$20}{\$500 + \$130 + \$150\ (15\%/35\%) + \$200\ (28\%/35\%)}$$

(h) *Coordination with section 904(f)*—(1) *In general*. Section 904(b) and this section shall apply before the provisions of section 904(f) as follows:

(i) The amount of a taxpayer's separate limitation income or loss in each separate category, the amount of overall foreign loss, and the amount of any additions to or recapture of separate limitation loss or overall foreign loss accounts pursuant to section 904(f) shall be determined after applying paragraphs (a), (c)(1), (d) and (e) of this section to adjust capital gains and losses and qualified dividend income from sources outside the United States in each separate category.

(ii) To the extent a capital loss from sources within the United States reduces a taxpayer's foreign source taxable income under paragraph (a)(1) of this section, such capital loss shall be disregarded in determining the amount of a taxpayer's taxable income from sources within the United States for purposes of computing the amount of any additions to the taxpayer's overall foreign loss accounts.

(iii) In determining the amount of a taxpayer's loss from sources in the United States under section 904(f)(5)(D) (section 904(f)(5)(D) amount), the taxpayer shall make appropriate adjustments to capital gains and losses from sources within the United States to reflect adjustments pursuant to section 904(b)(2) and this section. Therefore, for purposes of section 904, a taxpayer's section 904(f)(5)(D) amount shall be equal to the excess of the taxpayer's foreign source taxable income in all separate categories in the aggregate for the taxable year (taking into account any adjustments pursuant to paragraphs (a)(1), (c)(1), (d) and (e) of this section) over the taxpayer's entire taxable income for the taxable year (taking into account any adjustments pursuant to paragraphs (c)(2) and (e) of this section).

(2) *Examples*. The following examples illustrate the application of paragraph (h) of this section:

Example 1. (i) W, an individual, has the following items of ordinary income, capital gain, and capital loss for the taxable year:

	U.S. source	foreign source: general	passive
15% rate group	$500	$100	($400)
Ordinary income	$900	$100	

(ii) In computing W's taxable income from sources outside the United States for purposes of section 904 and this section, W must adjust the capital gain net income and net capital loss in each separate category as provided in paragraphs (c)(1) and (d) of this section. Thus, W must adjust the $100 of capital gain net income in the general limitation category and the $400 of net capital loss in the passive category as follows: $100(15%/35%) and $400(15%/35%).

(iii) After the adjustment to W's net capital loss in the passive category, W has a $171.43 separate limitation loss in the passive category. After the adjustment to W's capital gain in the general limitation category, W has $142.86 of foreign source taxable income in the general limitation category. Thus, $142.86 of the separate limitation loss reduces foreign source taxable income in the general limitation category. See section 904(f)(5)(B). W adds $142.86 to the separate limitation loss account for the passive category. The remaining $28.57 of the separate limitation loss reduces income from sources within the United States. See section 904(f)(5)(A). Thus, W adds $28.57 to the overall foreign loss account for the passive category.

Example 2. (i) X, a corporation, has the following items of ordinary income, ordinary loss, capital gain and capital loss for the taxable year:

	U.S. source	foreign source: general
Capital gain	($550)	$700
Ordinary income	$1100	($1000)

(ii) X's capital gain net income from sources outside the United States ($700) exceeds X's capital gain net income from all sources ($200). Pursuant to paragraph (a)(1) of this section, X must reduce the $700 capital gain in the general limitation category by $500. After the adjustment, X has $200 of capital gain net income remaining in the general limitation category. Thus, X has an overall foreign loss attributable to the general limitation category of $800.

(iii) For purposes of computing the amount of the addition to X's overall foreign loss account for the general limitation category, the $500 capital loss from sources within the United States is disregarded and X's taxable income from sources within the United States is $1100. Accordingly, X must increase its overall foreign loss account for the general limitation category by $800.

Example 3. (i) Y, a corporation, has the following items of ordinary income, ordinary loss, capital gain and capital loss for the taxable year:

	U.S. source	foreign source: general
Capital gain	($100)	$200
Ordinary income	($200)	$500

(ii) Y's capital gain net income from sources outside the United States ($200) exceeds Y's capital gain net income from all sources ($100). Pursuant to paragraph (a)(1) of this section, Y must reduce the $200 capital gain in the passive category by $100. Y has $100 of capital gain net income remaining in the passive category.

(iii) Y is not required to make adjustments pursuant to paragraph (c), (d) or (e) of this section. See paragraphs (b) and (e) of this section. Y's foreign source taxable income in the passive category after the adjustment pursuant to paragraph (a)(1) of this section is $600. Y's entire taxable income for the taxable year is $400.

(iv) Y's section 904(f)(5)(D) amount is the excess of Y's foreign source taxable income in all separate categories in the aggregate for the taxable year after taking into account the adjustment pursuant to paragraph (a)(1) of this section ($600) over Y's entire taxable income for the taxable year ($400). Therefore, Y's section 904(f)(5)(D) amount is $200 and Y's foreign source taxable income in the passive category is reduced to $400. See section 904(f)(5)(D).

Example 4. (i) Z, an individual, has the following items of ordinary income, ordinary loss and capital gain for the taxable year:

	U.S. source	foreign source: general	passive
15% rate group	$100		
Ordinary income	($200)	$300	$300

(ii) Z's foreign source taxable income in all of Z's separate categories in the aggregate for the taxable year is $600. (There are no adjustments to Z's foreign source taxable income pursuant to paragraph (a)(1), (c)(1), (d) or (e) of this section.)

(iii) In computing Z's entire taxable income in the denominator of the section 904(d) foreign tax credit limitation fractions, Z must adjust the $100 of net capital gain in the 15 percent rate group pursuant to paragraph (c)(2) of this section as follows: $100(15%/35%). Thus, Z's entire taxable income for the taxable year, taking into account the adjustment pursuant to paragraph (c)(2) of this section, is $442.86.

(iv) Z's section 904(f)(5)(D) amount is the excess of Z's foreign source taxable income in all separate categories in the aggregate for the taxable year ($600) over Z's entire taxable income for the taxable year after the adjustment pursuant to paragraph (c)(2) of this section ($442.86). Therefore, Z's section 904(f)(5)(D) amount is $157.32. This amount must be allocated *pro rata* to the passive and general limitation categories in accordance with section 904(f)(5)(D).

Example 5. (i) O, an individual, has the following items of ordinary income, ordinary loss and capital gain for the taxable year:

	U.S. source	foreign source: general	passive
15% rate group	$1100	($500)	
Ordinary income	($1000)	$1000	$500

(ii) In determining O's taxable income from sources outside the United States, O must reduce the $500 capital loss in the general limitation category to $214.29 ($500 x 15%/35%) pursuant to paragraph (d) of this section. Taking this adjustment into account, O's foreign source taxable income in all of O's separate categories in the aggregate is $1285.71 ($1000 - $214.29 + $500).

(iii) In computing O's entire taxable income in the denominator of the section 904(a) foreign tax credit limitation fraction, O must reduce the $600 of net capital gain for the year to $257.14 ($600 x 15%/35%) pursuant to paragraph (c)(2) of this section. Taking this adjustment into account, O's entire taxable income for the year is $757.14 ($500 + $257.14).

(iv) Therefore, O's section 904(f)(5)(D) amount is $528.57 ($1285.71 - $757.14). This amount must be allocated *pro rata* to O's $500 of income in the passive category and O's $785.71 of adjusted income in the general limitation category in accordance with section 904(f)(5)(D).

(i) *Effective date*. This section shall apply to taxable years beginning after July 20, 2004. Taxpayers may choose to apply this section and §1.904(b)–2 to taxable years ending after July 20, 2004.

Par. 7. Section 1.904(b)–2 is revised to read as follows:

§1.904(b)–2 Special rules for application of section 904(b) to alternative minimum tax foreign tax credit.

(a) *Application of section 904(b)(2)(B) adjustments*. Section 904(b)(2)(B) shall apply for purposes of determining the alternative minimum tax foreign tax credit under section 59 (regardless of whether or not the taxpayer has made an election under section 59(a)(4)).

(b) *Use of alternative minimum tax rates*—(1) *Taxpayers other than corporations*. In the case of a taxpayer other than a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59—

(i) Section 904(b)(3)(D)(i) shall be applied by using the language "section 55(b)(3)" instead of "subsection (h) of section 1";

(ii) Section 904(b)(3)(E)(ii)(I) shall be applied by using the language "section 55(b)(1)(A)(i)" instead of "subsection (a), (b), (c), (d), or (e) of section 1 (whichever applies)"; and

(iii) Section 904(b)(3)(E)(iii)(I) shall be applied by using the language "the alternative rate of tax determined under section 55(b)(3)" instead of "the alternative rate of tax determined under section 1(h)".

(2) *Corporate taxpayers*. In the case of a corporation, for purposes of determining the alternative minimum tax foreign tax credit under section 59, section 904(b)(3)(E)(ii)(II) shall be applied by using the language "section 55(b)(1)(B)" instead of "section 11(b)".

(c) *Effective date*. This section shall apply to taxable years beginning after July 20, 2004. See §1.904(b)–1(i) for a rule permitting taxpayers to choose to apply §1.904(b)–1(i) and this §1.904(b)–2 to taxable years ending after July 20, 2004.

§§1.904(b)–3 and 1.904(b)–4 [Removed]

Par. 8. Sections 1.904(b)–3 and 1.904(b)–4 are removed.

Par. 9. Section 1.904(j)–1 is added to read as follows:

§1.904(j)–1 Certain individuals exempt from foreign tax credit limitation.

(a) *Election available only if all foreign taxes are creditable foreign taxes*. A taxpayer may elect to apply section 904(j) for a taxable year only if all of the taxes for which a credit is allowable to the taxpayer under section 901 for the taxable year (without regard to carryovers) are creditable foreign taxes (as defined in section 904(j)(3)(B)).

(b) *Coordination with carryover rules*—(1) *No carryovers to or from election year*. If the taxpayer elects to apply section 904(j) for any taxable year, then no taxes paid or accrued by the taxpayer during such taxable year may be deemed paid or accrued under section 904(c) in any other taxable year, and no taxes paid or accrued in any other taxable year may be deemed paid or accrued under section 904(c) in such taxable year.

(2) *Carryovers to and from other years determined without regard to election years*. The amount of the foreign taxes paid or accrued, and the amount of the foreign source taxable income, in any year for which the taxpayer elects to apply section 904(j) shall not be taken into account in determining the amount of any carryover to or from any other taxable year. However, an election to apply section 904(j) to any year does not extend the number of taxable years to which unused foreign taxes may be carried under section 904(c) and §1.904–2(b). Therefore, in determining the number of such carryover years, the taxpayer must take into account years to which a section 904(j) election applies.

(3) *Determination of amount of creditable foreign taxes*. Otherwise allowable carryovers of foreign tax credits from other taxable years shall not be taken into account in determining whether the amount of creditable foreign taxes paid or accrued by an individual during a taxable year exceeds $300 ($600 in the case of a joint return) for purposes of section 904(j)(2)(B).

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

Example 1. In 2006, X, a single individual using the cash basis method of accounting for income and foreign tax credits, pays $100 of foreign taxes with respect to general limitation income that was earned and included in income for United States tax purposes in 2005. The foreign taxes would be creditable under section 901 but are not shown on a payee statement furnished to X. X's only income for 2006 from sources outside the United States is qualified passive income, with respect to which X pays $200 of creditable foreign taxes shown on a payee statement. X may not elect to apply section 904(j) for 2006 because some of X's foreign taxes are not creditable foreign taxes within the meaning of section 904(j)(3)(B).

Example 2. (i) In 2009, A, a single individual using the cash basis method of accounting for income and foreign tax credits, pays creditable foreign taxes of $250 attributable to passive income. Under section 904(c), A may also carry forward to 2009 $100 of unused foreign taxes paid in 2005 with respect to passive income, $300 of unused foreign taxes paid in 2005 with respect to general limitation income, $400 of unused foreign taxes paid in 2006 with respect to passive income, and $200 of unused foreign taxes paid in 2006 with respect to general limitation income. In 2009, A's only foreign source income is passive income described in section 904(j)(3)(A)(i), and this income is reported to A on a payee statement (within the meaning of section 6724(d)(2)). If A elects to apply section 904(j) for the 2009 taxable year, the unused foreign taxes paid in 2005 and 2006 are not deemed paid in 2009, and A therefore cannot claim a foreign tax credit for those taxes in 2009.

(ii) In 2010, A again is eligible for and elects the application of section 904(j). The carryforwards from 2005 expire in 2010. The carryforward period established under section 904(c) is not extended by A's election under section 904(j). In 2011, A does not elect the application of section 904(j). The $600 of unused foreign taxes paid in 2006 on passive and general limitation income are deemed paid in 2011, under section 904(c), without any adjustment for any portion of those taxes that might have been used as a foreign tax credit in 2009 or 2010 if A had not elected to apply section 904(j) to those years.

(d) *Effective date*. Section 1.904(j)–1 applies to taxable years beginning after July 20, 2004.

Par. 10. Section 1.954–2 is amended by:

1. Revising paragraph (b)(2)(iv), *Example 2*.

2. Removing paragraph (b)(2)(iv), *Example 3*.

The revision reads as follows:

§1.954–2 Foreign personal holding company income.

* * * * *

(b) * * *

(2) * * *

(iv) * * *

Example 2. (i) DS, a domestic corporation, wholly owns two controlled foreign corporations organized in Country A, CFC1 and CFC2. CFC1 purchases from DS property that DS manufactures in the United States. CFC1 uses the purchased property as a component part of property that CFC1 manufactures in Country A within the meaning of §1.954–3(a)(4). CFC2 provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property that CFC1 manufactures in Country A.

(ii) The interest accrued from the loans by CFC2 is not export financing interest as defined in section 904(d)(2)(G) because the property sold by CFC1 is not manufactured in the United States under §1.927(a)–1T(c). No portion of the interest is export financing interest as defined in this paragraph (b)(2). The full amount of the interest is, therefore, included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

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

Approved June 16, 2004.

Gregory F. Jenner,
Acting Assistant Secretary for Tax Policy.

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Section 954.—Foreign Base Company Income

Final regulations provide guidance on the exclusion of certain export financing interest from foreign personal holding company income. See T.D. 9141, page 359.

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rates Update

Notice 2004–56

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), and the weighted average interest rate and permissible ranges of interest rates based on the 30-year Treasury securities rate.

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, 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 or 2005 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, 2004–18 I.R.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 composite corporate bond rate for July 2004 is 6.00 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.

For Plan Years Beginning in: Month	Year	Corporate Bond Weighted Average	90% to 110% Permissible Range
August	2004	6.29	5.66 to 6.29

30-YEAR TREASURY SECURITIES WEIGHTED AVERAGE 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.

Section 404(a)(1) of the Code, as amended by the Pension Funding Equity Act of 2004, permits an employer to elect to disregard subclause (II) of § 412(b)(5)(B)(ii) to determine the maximum amount of the deduction allowed under § 404(a)(1).

The rate of interest on 30-year Treasury securities for July 2004 is 5.22 percent. Pursuant to Notice 2002–26, 2002–1 C.B. 743, 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 2031.

The following 30-year Treasury rates were determined for the plan years beginning in the month shown below.

For Plan Years Beginning in: Month	Year	30-Year Treasury Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
August	2004	5.16	4.65 to 5.42	4.65 to 5.68

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 1–877–829–5500 (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 1–202–283–9703. Mr. Montanaro may be reached at 1–202–283–9714. The telephone numbers in the preceding sentences are not toll-free.

Communications Excise Tax; Section 4251

Notice 2004–57

The Internal Revenue Service (Service) has received inquiries concerning the scope of the communications excise tax imposed by § 4251 of the Internal Revenue Code. These inquiries were precipitated, in part, by conflicting results in recent litigation. *Compare American Bankers Ins. Group v. United States*, 308 F. Supp. 2d 1360 (S.D. Fla. 2004), *appeal docketed*, No. 04–10720-EE (11^{th} Cir. Feb. 12, 2004) *with Office Max, Inc. v. United States*, 309 F. Supp. 2d 984 (N.D. Ohio 2004). This notice confirms that the Service will continue to assess and collect the tax under § 4251 on all taxable communications services, including those communications services similar to those at issue in the cases.

Persons paying for taxable communications services (taxpayers) are required to pay the tax to a collecting agent (the person receiving the payment on which tax is imposed), and collecting agents are required to pay over the tax to the United States Treasury and to file the required returns. Taxpayers may preserve any claims for overpayments by filing administrative claims for refund with the Service pursuant to § 6511.

Failure to pay the tax to the collecting agent may result in the imposition of penalties, as well as interest.

DRAFTING INFORMATION

The principal author of this notice is Cynthia A. McGreevy of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Ms. McGreevy at (202) 622–3130 (not a toll-free call).

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26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 2004–56

SECTION 1. PURPOSE

This Revenue Procedure provides model amendments that may be used by a State or local government eligible employer (as defined in § 457(e)(1)(A) of the Internal Revenue Code) to amend or draft its eligible § 457(b) plan to reflect the requirements of § 457 and the regulations thereunder.

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 Section 457 applies to nonqualified deferred compensation plans established by State and local government and tax-exempt employers. Under § 457, eligible employers may establish three different types of plans or arrangements: (1) eligible plans established by State and local government entities (eligible § 457(b) governmental plans); (2) eligible plans established by other tax-exempt entities (eligible § 457(b) plans of tax-exempt entities); and (3) ineligible plans under § 457(f). Under the last sentence of § 457(b), the Commissioner may notify an eligible § 457(b) governmental plan that it is administered in a manner that is inconsistent with § 457(b).

.02 Final regulations under § 457 (T.D. 9075, 2003–39 I.R.B 608) were published in the Federal Register (68 FR 41230) on July 11, 2003. These regulations replaced existing final regulations that were published in the Federal Register on September 27, 1982 (47 FR 42335) (T.D.7836, 1982–2 C.B. 91). The final regulations provide guidance for complying with the changes made to § 457 by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107–16 (EGTRRA), the Taxpayer Relief Act of 1997, Pub. L. No. 105–34 (TRA '97), and the Small Business Job Protection Act of 1996, Pub. L. No. 104–188 (SBJPA). The regulations also provide guidance on many non-EGTRRA issues, such as the tax treatment of excess deferrals, plan loans, plan terminations, and unforeseeable emergencies.

.03 Sections 615, 631, 632, 634, 635, 641, 646, 647, and 649 of EGTRRA made changes to eligible § 457(b) governmental plans, including increases in elective deferral limits, repeal of the rules coordinating the § 457 plan limits with contributions to certain other types of plans, catch-up contributions for individuals age 50 or over, extension of qualified domestic relation order rules to § 457 plans, rollovers to and from various types of eligible retirement plans, § 403(b) contracts and individual retirement arrangements (IRAs), and transfers to purchase permissive service credits under governmental defined benefit plans.

.04 Rev. Proc. 98–41, 1998–2 C.B. 135, provided model amendments that may be used for eligible § 457(b) governmental plans to reflect the revisions made to § 457 by the SBJPA, including the requirement that eligible § 457(b) governmental plans hold all assets and income in trust for the exclusive benefit of participants and beneficiaries.

SECTION 3. USE OF THE MODEL AMENDMENTS

Any State or local government employer may amend its eligible § 457(b) defined contribution governmental plan to comply with one or more of the changes made to § 457 by the SBJPA, TRA '97, EGTRRA, and the regulations issued under § 457 by adopting one or more of the Model Amendments contained in the Appendix to this revenue procedure. With respect to the benefit provisions relating to each of the Model Amendments, the Model Amendments have been prepared to conform with the applicable § 457(b) requirements, taking into account the general requirement that an eligible plan must include all of the material terms and conditions for benefits under the plan. For example, the Model Amendments do not incorporate the applicable legal requirements by reference, but instead describe those requirements in a manner intended to enable the plan administrator to implement the plan provisions on the basis of the language of the Model Amendments to the extent feasible.

The regulations provide that an eligible § 457(b) governmental plan may contain certain optional features not required for plan eligibility under § 457(b), such as in service distributions from rollover accounts, distributions for unforeseeable emergencies, loans, plan to plan transfers, and distributions of smaller accounts to eligible participants. Accordingly, these Model Amendments contain optional as well as required provisions that may be used in adopting an eligible § 457(b) governmental plan. However, if the optional provisions are used, the optional provisions must meet, in both form and operation, the relevant requirements under the

Code and the regulations, as well as operate in accordance with the terms of the plan.

SECTION 4. RELIANCE BY EMPLOYERS ON MODEL AMENDMENTS

If an eligible governmental employer adopts one or more of these Model Amendments for its plan that is intended to be an eligible § 457(b) governmental plan, the plan will be treated as meeting the plan requirements for eligibility under § 457(b) with respect to these provisions. An employer may adopt the applicable Model Amendment provided in this revenue procedure on a word-for-word basis or adopt an Amendment that is substantially similar in all material respects. However, these Model Amendments are limited in scope. Therefore, use of the Model Amendments does not have the same status as a private letter ruling which provides that a plan is an eligible § 457(b) governmental plan. In addition, if an eligible governmental employer adopts one or more of the Model Amendments, the plan must be operated in accordance with the Model Amendments and must continue to satisfy in both form and operation any other requirements of § 457 in order to maintain eligibility. To the extent an employer's plan does not include the Model Amendments or an amendment that is substantially similar in all respects, an eligible governmental employer who requests a private letter ruling from the IRS on plan eligibility under § 457 must clearly highlight and describe in the written request how its plan provisions differ from the Model Amendments.

SECTION 5. DATE AMENDMENTS ARE ADOPTED

Pursuant to this revenue procedure, for purposes of the last sentence of § 457(b), an eligible § 457(b) governmental plan will be treated as having adopted timely amendments to reflect the requirements of EGTRRA described in section 2.03 of this revenue procedure if the related Model Amendment, or any other amendment that satisfies that requirement, is adopted no later than December 31, 2005, the amendment is effective as of a date not later than the latest date permitted under § 457(b), and the operation of the plan since that date is not inconsistent with the amendment.

SECTION 6. AREAS NOT COVERED BY THIS REVENUE PROCEDURE

This revenue procedure does not apply to eligible § 457(b) plans of tax-exempt entities or ineligible plans under § 457(f).

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 98–41 is superseded.

SECTION 8. COMMENTS REQUESTED

Treasury and IRS are interested in receiving comments on the Model Amendments contained in this revenue procedure and any other Model Amendments that interested parties believe should be added to this revenue procedure. Comments should be sent to the following address: Internal Revenue Service, Attn: CC:DOM:CORP:R (Section 457 Plans), Room 5201, P. O. Box 7604, Ben Franklin Station, Washington, DC 20044. Written comments may be hand delivered Monday through Friday between 8 a.m. and 4 p.m. to: Internal Revenue Service, Courier's Desk, Attn: CC:PA:RU (Section 457 Plans), 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, written comments may be submitted electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting them directly to the IRS Internet site at *http:/www.irs.gov/tax_regs/reglist.html.* Comments should be received by November 30, 2004.

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1904.

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.

The collection of information in this revenue procedure is pursuant to § 457(b) of the Code and § 1.457–1 of the Income Tax Regulations. Sections 2.2, 2.4, and 2.6 of the Appendix to this revenue procedure deal with the election to defer compensation and the information that has to be provided to the administrator of the plan by a participant in the plan. Sections 5.2, 5.3, 5.4, 5.10 and 6.3 of the Appendix to this revenue procedure deal with the participant's rights to distribution and the notification that the participant must give to the administrator of the plan. Section 8.6 of the Appendix to this revenue procedure deals with the procedure that an administrator of a plan must follow when distributees cannot be located. This information is required to enable sponsors of plans of state or local governments described in this revenue procedure to make the necessary amendments to ensure compliance with the statutory requirements of § 457(b) and the regulations thereunder. The likely respondents are state or local governments.

The estimated total annual reporting and/or recordkeeping burden is 41,040 hours.

The estimated annual burden per respondent/recordkeeper varies from 3 to 8 hours, depending on individual circumstances, with an estimated average of 4 hours. The estimated number of respondents and/or recordkeepers is 10,260.

The estimated frequency of responses is occasional.

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

DRAFTING INFORMATION

The principal author of this revenue procedure is Vernon S. Carter of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue procedure, contact Vernon S. Carter at (202) 622–6060 (not a toll-free call).

APPENDIX FOR REVENUE PROCEDURE 2004–56
MODEL AMENDMENTS

Note to sponsors: *The Model Amendments in this Appendix are designed for use by eligible governmental employers maintaining eligible § 457(b) defined contribution plans that permit employees to elect to defer compensation, that are maintained on the basis of the calendar year, and that provide for the use of one or more trusts to satisfy the requirements of § 457(g). In this Appendix presenting the Model Amendment language, the portions printed in italics are explanatory notes for the benefit of the §457(b) plan sponsor and are not to be included in the Model Amendments. In addition, certain items indicated by brackets can be filled in by the plan sponsor as required or as appropriate.*

MODEL AMENDMENT 1
Definition of Terms

Section 1
Definition of Terms Used in Model Amendments

The following words and terms, when used in the Model Amendments, have the meaning set forth below and should be adopted as part of the corresponding Model Amendment, as identified at the end of each definition below and also as identified at the end of each Model Amendment.

1.1 ***"Administrator"***: [Insert Identity of person, committee or organization appointed to administer the Plan]. ***Note:*** *This definition is used in Model Amendments 2, 3, 4, 5, 6, and 8*.

1.2 **"Account Balance"**: The bookkeeping account maintained with respect to each Participant which reflects the value of the deferred Compensation credited to the Participant, including the Participant's Annual Deferrals, the earnings or loss of the Fund (net of Fund expenses) allocable to the Participant, any transfers for the Participant's benefit, and any distribution made to the Participant or the Participant's Beneficiary. If a Participant has more than one Beneficiary at the time of the Participant's death, then a separate Account Balance shall be maintained for each Beneficiary. The Account Balance includes any account established under Section 6 for rollover contributions and plan-to-plan transfers made for a Participant, the account established for a Beneficiary after a Participant's death, and any account or accounts established for an alternate payee (as defined in section 414(p)(8) of the Code). ***Note:*** *This definition is used in Model Amendments 2, 3, 4, 5, 6, and 8*.

Note: *A plan is not required to maintain a separate account for each Beneficiary in order to satisfy section 401(a)(9), but this Model Amendment provides for such separate accounts so that installment payments are permitted to be made over each beneficiary's life expectancy as permitted under § 1.401(a)(9)–8, A–2(a)(2) of the Income Tax Regulations. However, because, under the Model Amendment, each separate account is permitted to have only a single beneficiary, certain beneficiary designations are not permitted under the Model Amendment, such as a death benefit in the form of a fixed dollar payment that is not determined as of the date of death and that is not to be maintained in a separate account to which gains and losses are credited.*

1.3 **"Annual Deferral"**: The amount of Compensation deferred in any year. ***Note:*** *This definition is used in Model Amendments 2, 3, 4, 5, 6 and 7*.

1.4 **"Beneficiary"**: The designated person (or, if none, the Participant's estate) who is entitled to receive benefits under the Plan after the death of a Participant. ***Note:*** *This definition is used in Model Amendments 2, 4, 5, 6 and 8*.

1.5 **"Code"**: The Internal Revenue Code of 1986, as now in effect or as hereafter amended. All citations to sections of the Code are to such sections as they may from time to time be amended or renumbered. ***Note:*** *This definition is used in Model Amendments 2, 3, 4, 5, 6, 7, and 8*.

1.6 **"Compensation"**: All cash compensation for services to the Employer, including salary, wages, fees, commissions, bonuses, and overtime pay, that is includible in the Employee's gross income for the calendar year, plus amounts that would be cash compensation for services to the Employer includible in the Employee's gross income for the calendar year but for a compensation reduction election under section 125, 132(f), 401(k), 403(b), or 457(b) of the Code (including an election to defer compensation under Section 3). ***Note:*** *This definition is used in Model Amendments 2, 3, 4, and 5*.

1.7 **"Employee"**: Each natural person, whether appointed or elected, who is employed by the Employer as a common law employee, excluding any employee who is included in a unit of employees covered by a collective bargaining agreement that does not specifically provide for participation in the Plan. ***Note:*** *This definition is used in Model Amendments 2, 3, 4, and 6*.

Note: *A plan is not required to be offered to all employees and may provide for specific classes of employees to be excluded.*

1.8 **"Employer"**: [Name of State entity]. ***Note:*** *This definition is used in Model Amendments 2, 3, 4, 6, and 8.*

Note: *State means a State (treating the District of Columbia as a State as provided under § 7701(a)(10)), a political subdivision of a State, and any agency or instrumentality of a State*.

1.9 **"Includible Compensation"**: An Employee's actual wages in box 1 of Form W–2 for a year for services to the Employer, but subject to a maximum of $200,000 (or such higher maximum as may apply under section 401(a)(17) of the Code) and increased (up to the dollar maximum) by any compensation reduction election under section 125, 132(f), 401(k), 403(b), or 457(b) of the Code (including an election to defer Compensation under Section 3). ***Note:*** *This definition is used in Model Amendment 3*.

1.10 **"Normal Retirement Age"**: Age 65. ***Note:*** *This definition is used in Model Amendments 3 and 5. See Note after Section 3.3*.

1.11 **"Participant"**: An individual who is currently deferring Compensation, or who has previously deferred Compensation under the Plan by salary reduction and who has not received a distribution of his or her entire benefit under the Plan. Only individuals who perform services for the Employer as an Employee may defer Compensation under the Plan. ***Note:*** *This definition is used in Model Amendments 2, 3, 4, 5, 6, 7, and 8*.

1.12 **"Plan"**: [INSERT NAME OF PLAN]. ***Note:*** *This definition is used in Model Amendments 2, 3, 4, 5, 6, 7 and 8*.

1.13 **"Severance from Employment"**: The term Severance from Employment means the date that the Employee dies, retires, or otherwise has a severance from employment with the Employer, as determined by the Administrator (and taking into account guidance issued under the Code). ***Note:*** *This definition is used in Model Amendments 2, 4, 5, and 6*.

1.14 **"Trust Agreement"**: The written agreement (or declaration) made by and between the Employer and the Trustee under which the Trust Fund is maintained. ***Note:*** *This definition is used in Model Amendment 7*.

1.15 **"Trust Fund"**: The trust fund created under and subject to the Trust Agreement. ***Note:*** *This definition is used in Model Amendments 2, 7, and 8*.

1.16 **"Trustee"**: The Trustee duly appointed and currently serving under the Trust Agreement. ***Note:*** *This definition is used in Model Amendments 4, 5, 7 and 8*.

1.17 **"Valuation Date"**: [Each business day/The last day of the calendar month/The last day of the calendar quarter/Each December 31]. ***Note:*** *This definition is used in Model Amendments 4 and 5*.

MODEL AMENDMENT 2
Participation and Contributions

Section 2
Participation and Contributions

2.1 ***Eligibility***. Each Employee shall be eligible to participate in the Plan and defer Compensation hereunder immediately upon becoming employed by the Employer.

Note: *As indicated above, this Model Amendment assumes that the employer has a broad based plan with an immediate eligibility, that the plan is limited to elective contributions, and that the plan has no matching or other employer non-elective contributions*.

2.2 ***Election Required for Participation***. An Employee may elect to become a Participant by executing an election to defer a portion of his or her Compensation (and have that amount contributed as an Annual Deferral on his or her behalf) and filing it with the Administrator. This participation election shall be made on the deferral agreement provided by the Administrator under which the Employee agrees to be bound by all the terms and conditions of the Plan. The Administrator may establish a minimum deferral amount, and may change such minimums from time to time. The participation election shall also include designation of investment funds and a designation of Beneficiary. Any such election shall remain in effect until a new election is filed.

2.3 ***Commencement of Participation***. An Employee shall become a Participant as soon as administratively practicable following the date the Employee files a participation election pursuant to Section 2.2. Such election shall become effective no earlier than the calendar month following the month in which the election is made. A new Employee may defer compensation payable in the calendar month during which the Participant first becomes an Employee if an agreement providing for the deferral is entered into on or before the first day on which the Participant performs services for the Employer.

2.4 ***Information Provided by the Participant***. Each Employee enrolling in the Plan should provide to the Administrator at the time of initial enrollment, and later if there are any changes, any information necessary or advisable for the Administrator to administer the plan, including, without limitation, whether the Employee is a participant in any other eligible plan under Code section 457(b).

2.5 ***Contributions Made Promptly***. Annual Deferrals by the Participant under the Plan shall be transferred to the Trust Fund within a period that is not longer than is reasonable for the proper administration of the Participant's Account Balance. For this purpose, Annual Deferrals shall be treated as contributed within a period that is not longer than is reasonable for the proper administration if the contribution is made to the Trust Fund within 15 business days following the end of the month in which the amount would otherwise have been paid to the Participant.

2.6 ***Amendment of Annual Deferrals Election***. Subject to other provisions of the Plan, a Participant may at any time revise his or her participation election, including a change of the amount of his or her Annual Deferrals, his or her investment direction and his or her designated Beneficiary. Unless the election specifies a later effective date, a change in the amount of the Annual Deferrals shall take effect as of the first day of the next following month or as soon as administratively practicable if later. A change in the investment direction shall take effect as of the date provided by the Administrator on a uniform basis for all Employees. A change in the Beneficiary designation shall take effect when the election is accepted by the Administrator.

2.7 ***Leave of Absence***. Unless an election is otherwise revised, if a Participant is absent from work by leave of absence, Annual Deferrals under the Plan shall continue to the extent that Compensation continues.

2.8 ***Disability***. A disabled Participant may elect Annual Deferrals during any portion of the period of his or her disability to the extent that he or she has actual Compensation (not imputed Compensation and not disability benefits) from which to make contributions to the Plan and has not had a Severance from Employment.

Note: *The following definitions from Model Amendment 1 are used in this Model Amendment 2: Administrator, Account Balance, Annual Deferral, Beneficiary, Employee, Participant, Plan, Severance from Employment, and Trust Fund.*

MODEL AMENDMENT 3
Limitations on Amounts Deferred

Section 3
Limitations on Amounts Deferred

3.1 ***Basic Annual Limitation.*** The maximum amount of the Annual Deferral under the Plan for any calendar year shall not exceed the lesser of (i) the Applicable Dollar Amount or (ii) the Participant's Includible Compensation for the calendar year. The Applicable Dollar Amount is the amount established under section 457(e)(15) of the Code applicable as set forth below:

For the following years:	The Applicable Dollar Amount is:
2002	$11,000
2003	$12,000
2004	$13,000
2005	$14,000
2006 or thereafter	$15,000 Adjusted for cost-of-living after 2006 to the extent provided under section 415(d) of the Code.

3.2 ***Age 50 Catch-up Annual Deferral Contributions***. A Participant who will attain age 50 or more by the end of the calendar year is permitted to elect an additional amount of Annual Deferrals, up to the maximum age 50 catch-up Annual Deferrals for the year. The maximum dollar amount of the age 50 catch-up Annual Deferrals for a year is as follows:

For the following years:	The maximum age 50 catch-up dollar amount is:
2002	$1,000
2003	$2,000
2004	$3,000
2005	$4,000
2006 or thereafter	$5,000, adjusted for cost-of-living after 2006 to the extent provided under the Code.

3.3 ***Special Section 457 Catch-up Limitation***. If the applicable year is one of a Participant's last 3 calendar years ending before the year in which the Participant attains Normal Retirement Age and the amount determined under this Section 3.3 exceeds the amount computed under Sections 3.1 and 3.2, then the Annual Deferral limit under this Section 3 shall be the lesser of:

(a) An amount equal to 2 times the Section 3.1 Applicable Dollar Amount for such year; or

(b) The sum of:

(1) An amount equal to (A) the aggregate Section 3.1 limit for the current year plus each prior calendar year beginning after December 31, 2001, during which the Participant was an Employee under the Plan, minus (B) the aggregate amount of Compensation that the Participant deferred under the Plan during such years, plus

(2) An amount equal to (A) the aggregate limit referred to in section 457(b)(2) of the Code for each prior calendar year beginning after December 31, 1978, and before January 1, 2002, during which the Participant was an Employee (determined without regard to Sections 3.2 and 3.3), minus (B) the aggregate contributions to Pre–2002 Coordination Plans for such years.

However, in no event can the deferred amount be more than the Participant's Compensation for the year. ***Note:*** *This limitation is required because the Model Amendment is limited to elective contributions.*

Note: *Generally, for purposes of the special § 457 catch-up definition in Section 3.3, a plan must specify the normal retirement age under the plan. A plan may define normal retirement age as any age that is on or after the earlier of age 65 or the age at which participants have the right to retire and receive, under the basic defined benefit pension plan of the employer (or a money purchase pension plan in which the participant also participates if the participant is not eligible to participate in a defined benefit plan), immediate retirement benefits without actuarial or similar reduction because of retirement before some later specified age, and that is not later than age 70½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within these ages. For purposes of the special § 457 catch-up in Section 3.3, an entity sponsoring more than one eligible plan may not permit a participant to have more than one normal retirement age under the eligible plans it sponsors.*

Note: *<u>Special rule for eligible plans of qualified police or firefighters</u>. An eligible plan with participants that include qualified police or firefighters as defined under § 415(b)(2)(H)(ii)(I) of the Code may designate a normal retirement age for such qualified police or firefighters that is earlier than the earliest normal retirement age designated under the general rule above, but in no event may the normal retirement age be earlier than age 40. Alternatively, a plan may allow a qualified police or firefighter participant to designate a normal retirement age that is between age 40 and age 70½.*

3.4 ***Special Rules***. For purposes of this Section 3, the following rules shall apply:

(a) *Participant Covered By More Than One Eligible Plan*. If the Participant is or has been a participant in one or more other eligible plans within the meaning of section 457(b) of the Code, then this Plan and all such other plans shall be considered as one plan for purposes of applying the foregoing limitations of this Section 3. For this purpose, the Administrator shall take into account any other such eligible plan maintained by the Employer and shall also take into account any other such eligible plan for which the Administrator receives from the Participant sufficient information concerning his or her participation in such other plan.

(b) *Pre-Participation Years*. In applying Section 3.3, a year shall be taken into account only if (i) the Participant was eligible to participate in the Plan during all or a portion of the year and (ii) Compensation deferred, if any, under the Plan during the year was subject to the Basic Annual Limitation described in Section 3.1 or any other plan ceiling required by section 457(b) of the Code.

(c) *Pre–2002 Coordination Years*. For purposes of Section 3.3(b)(2)(B), "contributions to Pre–2002 Coordination Plans" means any employer contribution, salary reduction or elective contribution under any other eligible Code section 457(b) plan, or a salary reduction or elective contribution under any Code section 401(k) qualified cash or deferred arrangement, Code section 402(h)(1)(B) simplified employee pension (SARSEP), Code section 403(b) annuity contract, and Code section 408(p) simple retirement account, or under any plan for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18) of the Code, including plans, arrangements or accounts maintained by the Employer or any employer for whom the Participant performed services. However, the contributions for any calendar year are only taken into account for purposes of Section 3.3(b)(2)(B) to the extent that the total of such contributions does not exceed the aggregate limit referred to in section 457(b)(2) of the Code for that year.

Note: *See generally § 1.457–4(c)(3)(iv) of the Income Tax Regulations for rules relating to the application of the coordination limit for years prior to 2002 for purposes of determining the underutilized limit.*

(d) *Disregard Excess Deferral*. For purposes of Sections 3.1, 3.2 and 3.3, an individual is treated as not having deferred compensation under a plan for a prior taxable year to the extent Excess Deferrals under the plan are distributed, as described in Section 3.5. To the extent that the combined deferrals for pre–2002 years exceeded the maximum deferral limitations, the amount is treated as an Excess Deferral for those prior years.

3.5 ***Correction of Excess Deferrals***. If the Annual Deferral on behalf of a Participant for any calendar year exceeds the limitations described above, or the Annual Deferral on behalf of a Participant for any calendar year exceeds the limitations described above when combined with other amounts deferred by the Participant under another eligible deferred compensation plan under section 457(b) of the Code for which the Participant provides information that is accepted by the Administrator, then the Annual Deferral, to the extent in excess of the applicable limitation (adjusted for any income or loss in value, if any, allocable thereto), shall be distributed to the Participant. ***Note:*** *See § 1.457–4(e)(1) of the Income Tax Regulations for the federal income tax treatment of a distribution of excess deferrals.*

Note: *See generally §§ 1.457–4 and 1.457–5 of the Income Tax Regulations for rules relating to limitations on contributions.*

3.6 ***Protection of Persons Who Serve in a Uniformed Service***. An Employee whose employment is interrupted by qualified military service under Code section 414(u) or who is on a leave of absence for qualified military service under Code section 414(u) may elect to make additional Annual Deferrals upon resumption of employment with the Employer equal to the maximum Annual Deferrals that the Employee could have elected during that period if the Employee's employment with the Employer had continued (at the same level of Compensation) without the interruption or leave, reduced by the Annual Deferrals, if any, actually made for the Employee during the period of the interruption or leave. This right applies for five years following the resumption of employment (or, if sooner, for a period equal to three times the period of the interruption or leave).

Note: *The following definitions from Model Amendment 1 are used in this Model Amendment 3: Administrator, Account Balance, Annual Deferral, Code, Compensation, Employee, Includible Compensation, Normal Retirement Age, Participant, and Plan.*

MODEL AMENDMENT 4
Loans

Section 4
Loans

4.1 ***Loans.*** A Participant who is an Employee may apply for and receive a loan from his or her Account Balance as provided in this Section 4. Any such loan may not be for an amount less than the minimum amount specified by the Administrator. If not specified by the Administrator, the minimum loan amount shall be [$1,000].

4.2 ***Maximum Loan Amount.*** No loan to a Participant hereunder may exceed the lesser of:

(a) $50,000, reduced by the greater of (i) the outstanding balance on any loan from the Plan to the Participant on the date the loan is made or (ii) the highest outstanding balance on loans from the Plan to the Participant during the one-year period ending on the day before the date the loan is approved by the Administrator (not taking into account any payments made during such one-year period), or

(b) one half of the value of the Participant's vested Account Balance (as of the Valuation Date immediately preceding the date on which such loan is approved by the Administrator).

For purposes of this Section 4.2, any loan from any other plan maintained by a participating employer shall be treated as if it were a loan made from the Plan, and the Participant's vested interest under any such other plan shall be considered a vested interest under this Plan; provided, however, that the provisions of this paragraph shall not be applied so as to allow the amount of a loan under this Section 4.2 to exceed the amount that would otherwise be permitted in the absence of this paragraph.

4.3 ***Terms of Loan.*** The terms of the loan shall:

(a) require level amortization with payments not less frequently than quarterly throughout the repayment period, except that alternative arrangements for repayment may apply in the event that the borrower is on an *bona fide* unpaid leave of absence for a period not to exceed one year for leaves other than a qualified military leave within the meaning of section 414(u) of the Code or for the duration of a leave which is due to qualified military service;

(b) require that the loan be repaid within five years unless the Participant certifies in writing to the Administrator that the loan is to be used to acquire any dwelling unit which within a reasonable time is to be used (determined at the time the loan is made) as a principal residence of the Participant; and

(c) provide for interest at a rate equal to one percentage point above the prime rate as published in the *[Insert name of a nationally recognized newspaper that publishes the prime rate daily]* on the first business day of the month in which the loan is approved by the Administrator.

4.4 ***Security for Loan; Default.***

(a) *Security*. Any loan to a Participant under the Plan shall be secured by the pledge of the portion of the Participant's interest in the Plan invested in such loan.

(b) *Default*. In the event that a Participant fails to make a loan payment under this Section 4 within 90 days after the date such payment is due, a default on the loan shall occur. In the event of such default, (i) all remaining payments on the loan shall be immediately due and payable, (ii) effective as of the first day of the calendar month next following the month in which any such loan default occurs, the interest rate for such loan shall be (if higher than the rate otherwise applicable) the rate being charged on loans from the Plan that are approved by the Administrator in the month in which such default occurs, (iii) no contributions shall be made on such Participant's behalf prior to the first payroll period that follows by 12 calendar months the date of repayment in full of such loan, and (iv) the Participant shall be permanently ineligible for any future loans from the Plan.

In the case of any default on a loan to a Participant, the Administrator shall apply the portion of the Participant's interest in the Plan held as security for the loan in satisfaction of the loan on the date of Severance from Employment. In addition, the Administrator shall take any legal action it shall consider necessary or appropriate to enforce collection of the unpaid loan, with the costs of any legal proceeding or collection to be charged to the Account Balance of the Participant.

Notwithstanding anything elsewhere in the Plan to the contrary, in the event a loan is outstanding hereunder on the date of a Participant's death, his or her estate shall be his or her Beneficiary as to the portion of his or her interest in the Plan invested in such loan (with the Beneficiary or Beneficiaries as to the remainder of his or her interest in the Plan to be determined in accordance with otherwise applicable provisions of the Plan).

4.5 ***Repayment.*** The Participant shall be required, as a condition to receiving a loan, to enter into an irrevocable agreement authorizing the Employer to make payroll deductions from his or her Compensation as long as the Participant is an Employee and to transfer such payroll deduction amounts to the Trustee in payment of such loan plus interest. Repayments of a loan shall be made by payroll deduction of equal amounts (comprised of both principal and interest) from each paycheck, with the first such deduction to be made as soon as practicable after the loan funds are disbursed; provided however, that a Participant may prepay the entire outstanding balance of his loan at any time (but may not make a partial prepayment); and provided, further, that if any payroll deductions cannot be made in full because a Participant is on an unpaid leave of absence or is no longer employed by a participating employer (that has consented to make payroll deductions for this purpose) or the Participant's paycheck is insufficient for any other reason, the Participant shall pay directly to the Plan the full amount that would have been deducted from the Participant's paycheck, with such payment to be made by the last business day of the calendar month in which the amount would have been deducted.

Note: *Loans are not required to be repaid by payroll withholding. See § 1.457–6(f)(2) of the Income Tax Regulations for additional rules that may apply if loans are not repaid by payroll withholding.*

Note: *See § 1.72(p)–1 of the Income Tax Regulations for the federal income tax treatment of loans generally.*

Note: *The following definitions from Model Amendment 1 are used in this Model Amendment 4: Administrator, Account Balance, Code, Compensation, Employee, Employer, Severance from Employment, Participant, Plan, Trustee and Valuation Date.*

MODEL AMENDMENT 5
Distribution of Benefits

Section 5
Benefit Distributions

5.1 ***Benefit Distributions At Retirement or Other Severance from Employment***. Upon retirement or other Severance from Employment (other than due to death), a Participant is entitled to receive a distribution of his or her Account Balance under any form of distribution permitted under Section 5.3 commencing at the date elected under Section 5.2. If a Participant does not elect otherwise, the distribution shall be paid as soon as practicable following Normal Retirement Age or, if later, following retirement or other Severance from Employment and payment shall be made in [quarterly] [monthly] installments of the minimum annual payments described in paragraph (b) of Section 5.3.

5.2 ***Election of Benefit Commencement Date.*** A Participant may elect to commence distribution of benefits at any time after retirement or other Severance from Employment by a notice filed at least [30 days] before the date on which benefits are to commence. However, in no event may distribution of benefits commence later than the date described in Section 5.8.

5.3 ***Forms of Distribution***. In an election to commence benefits under Section 5.2, a Participant entitled to a distribution of benefits under this Section 5 may elect to receive payment in any of the following forms of distribution:

(a) a lump sum payment of the total Account Balance or

(b) annual installment payments through the year of the Participant's death, the amount payable each year equal to a fraction of the Account Balance equal to one divided by the distribution period set forth in the Uniform Lifetime Table at section 1.401(a)(9)–9, A–2, of the Income Tax Regulations for the Participant's age on the Participant's birthday for that year. If the Participant's age is less than age 70, the distribution period is 27.4 plus the number of years that the Participant's age is less than age 70. At the Participant's election, this annual payment can be made in monthly or quarterly installments. The Account Balance for this calculation (other than the final installment payment) is the Account Balance as of the end of the year prior to the year for which the distribution is being calculated. Payments shall commence on the date elected under Section 5.2. For any year, the Participant can elect distribution of a greater amount (not to exceed the amount of the remaining Account Balance) in lieu of the amount calculated using this formula.

5.4 ***Death Benefit Distributions***. Commencing in the calendar year following the calendar year of the Participant's death, the Participant's Account Balance shall be paid to the Beneficiary in a lump sum.

Alternatively, if the Beneficiary with respect to the Participant's Account Balance is a natural person, at the Beneficiary's election, distribution can be made in annual installments (calculated in a manner that is similar to installments under Section 5.3) with the distribution period determined under this paragraph. If the Beneficiary is the Participant's surviving spouse, the distribution period is equal to the Beneficiary's life expectancy using the single life table in section 1.401(a)(9)–9, A–1, of the Income Tax Regulations for the spouse's age on the spouse's birthday for that year. If the Beneficiary is not the Participant's surviving spouse, the distribution period is the Beneficiary's life expectancy determined in the year following the year of the Participant's death using the single life table in section 1.401(a)(9)–9, A–1, of the Income Tax Regulations for the Beneficiary's age on the Beneficiary's birthday for that year, reduced by one for each year that has elapsed after that year. For any year, a Beneficiary can elect distribution of a greater amount (not to exceed the amount of the remaining Account Balance) in lieu of the amount calculated using this formula.

Note: *A plan is not required to include the particular forms of payment that are in Section 5.3 and Section 5.4, and may include additional forms of payment so long as the material terms and conditions for those other forms are set forth in the plan and the additional forms of payment satisfy the requirements of § 401(a)(9) of the Code.*

5.5 ***Account Balances of $5,000 or Less***. Notwithstanding Sections 5.2, 5.3 and 5.4, if the amount of a Participant's Account Balance is not in excess of $5,000 (or the dollar limit under section 411(a)(11) of the Code, if greater) on the date that payments commence under Section 5.3 or on the date of the Participant's death, then payment shall be made to the Participant (or to the Beneficiary if the Participant is deceased) in a lump sum equal to the Participant's Account Balance as soon as practicable following the Participant's retirement, death, or other Severance from Employment.

5.6 ***Amount of Account Balance***. Except as provided in Section 5.3, the amount of any payment under this Section 5 shall be based on the amount of the Account Balance on the preceding Valuation Date.

5.7 ***Revocation of Prior Election***. Any election made under this Section 5 may be revoked at any time.

5.8 ***Latest Distribution Date***. In no event shall any distribution under this Section 5 begin later than the later of (a) April 1 of the year following the calendar year in which the Participant attains age $70^1/_2$ or (b) April 1 of the year following the year in which the Participant retires or otherwise has a Severance from Employment. If distributions commence in the calendar year following the later of the calendar year in which the Participant attains age $70^1/_2$ or the calendar year in which the Severance from Employment occurs, the distribution on the date that distribution commences must be equal to the annual installment payment for the year that the Participant has a Severance from Employment determined under paragraph (b) of Section 5.3 and an amount equal to the annual installment payment for the year after Severance from Employment determined under paragraph (b) of Section 5.3 must also be paid before the end of the calendar year of commencement.

5.9 ***In-Service Distributions From Rollover Account***. If a Participant has a separate account attributable to rollover contributions to the plan, the Participant may at any time elect to receive a distribution of all or any portion of the amount held in the rollover account.

Note: *A plan is not required to permit in-service distribution from a rollover account. See Rev. Rul. 2004–12, 2004–7 I.R.B. 478.*

5.10 ***Unforeseeable Emergency Distribution***.

(a) *Distribution*. If the Participant has an unforeseeable emergency before retirement or other Severance from Employment, the Participant may elect to receive a lump sum distribution equal to the amount requested or, if less, the maximum amount determined by the Administrator to be permitted to be distributed under this Section 5.10.

(b) *Unforeseeable emergency defined*. An unforeseeable emergency is defined as a severe financial hardship of the Participant resulting from: an illness or accident of the Participant, the Participant's spouse, or the Participant's dependent (as defined in section 152(a)); loss of the Participant's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by homeowner's insurance, *e.g.*, as a result of a natural disaster); the need to pay for the funeral expenses of the Participant's spouse or dependent (as defined in section 152(a) of the Code); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the Participant. For example, the imminent foreclosure of or eviction from the Participant's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the cost of prescription drug medication, may constitute an unforeseeable emergency. Except as otherwise specifically provided in this Section 5.10, neither the purchase of a home nor the payment of college tuition is an unforeseeable emergency.

(c) *Unforeseeable emergency distribution standard*. A distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the Participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship, or by cessation of deferrals under the plan.

(d) *Distribution necessary to satisfy emergency need*. Distributions because of an unforeseeable emergency may not exceed the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution).

5.11 ***Mandatory Distributions for Certain Account Balances of $5,000 or Less***. At the direction of the Administrator, a Participant's total Account Balance shall be paid in a lump sum as soon as practical following the direction if (a) the total Account Balance does not exceed $5,000 (or the dollar limit under section 411(a)(11) of the Code, if greater), (b) the Participant has not previously received a distribution of the total amount payable to the Participant under this Section 5.11 and (c) no Annual Deferral has been made with respect to the Participant during the two-year period ending immediately before the date of the distribution.

Note: *This Model Amendment (Section 5.11) may be adopted for a § 457(b) plan to provide for the mandatory de minimis distribution option permitted under § 457(e)(9)(A) of the Code. If it wishes, the plan sponsor may also substitute in the following Model Amendments a consistent figure lower than $5,000 in place of "$5,000 (or the dollar limit under § 411(a)(11) of the Code, if greater)." In addition, the plan may allow participants to choose whether or not they wish to receive payment under this provision.*

5.12 ***Rollover Distributions***.

(a) A Participant or the surviving spouse of a Participant (or a Participant's former spouse who is the alternate payee under a domestic relations order, as defined in section 414(p) of the Code) who is entitled to an eligible rollover distribution may elect, at the time and in the manner prescribed by the Administrator, to have all or any portion of the distribution paid directly to an eligible retirement plan specified by the Participant in a direct rollover.

(b) For purposes of this Section 5.12, an eligible rollover distribution means any distribution of all or any portion of a Participant's Account Balance, except that an eligible rollover distribution does not include (a) any installment payment under Section 5.3 for a period of 10 years or more (b) any distribution made under Section 5.10 as a result of an unforeseeable emergency, or (c) for any other distribution, the portion, if any, of the distribution that is a required minimum distribution under section 401(a)(9). In addition, an eligible retirement plan means an individual retirement account described in section 408(a) of the Code, an individual retirement annuity described in section 408(b) of the Code, a qualified trust described in section 401(a) of the Code, an annuity plan described in section 403(a) or 403(b) of the Code, or an eligible governmental plan described in section 457(b) of the Code, that accepts the eligible rollover distribution.

Note: *Section 402(f) and § 457(e)(16)(B) of the Code require a plan administrator to provide a written explanation to any recipient of an eligible rollover distribution. The written explanation must cover the direct rollover rules, the mandatory income tax withholding on distributions not directly rolled over, the tax treatment of distributions not rolled over (including the special tax treatment available for certain lump sum distributions), and when distributions may be subject to different restrictions and tax consequences after being rolled over. Section 402(f) provides that this explanation must be given within a reasonable period of time before the plan makes an eligible rollover distribution. See Notice 2002–3, 2002–1 C.B. 289 that contains a Safe Harbor Explanation that plan administrators may provide to recipients of eligible rollover distributions from employer plans in order to satisfy the notice requirement.*

Note: In determining the portion of any distribution that is a required minimum distribution for a year and thus not an eligible rollover distribution, for any participant who, during the calendar year of distribution, is age 70½ or older and who has had a Severance from Employment, the amount of the minimum annual installment payment described in paragraph (b) of Section 5.3 may be treated as the amount of the required minimum distribution. For distributions to a surviving spouse, any distribution made before the calendar year in which the participant would have attained age 70½ is not a required minimum distribution. For the calendar year in which the participant would have attained age 70½ or any later year, the amount of the minimum annual installment payment described in paragraph (b) of Section 5.3 may be treated as the amount of the required minimum distribution.

***Note:** See generally § 1.457–6 of the Income Tax Regulations for rules relating to restrictions on distributions.*

***Note:** The following definitions from Model Amendment 1 are used in this Model Amendment 5: Administrator, Account Balance, Annual Deferral, Beneficiary, Code, Normal Retirement Age, Participant, Plan, Severance from Employment, and Valuation Date.*

MODEL AMENDMENT 6
Rollovers to the Plan and Transfers

Section 6
Rollovers to the Plan and Transfers

6.01 ***Eligible Rollover Contributions to the Plan.***

(a) A Participant who is an Employee and who is entitled to receive an eligible rollover distribution from another eligible retirement plan may request to have all or a portion of the eligible rollover distribution paid to the Plan. The Administrator may require such documentation from the distributing plan as it deems necessary to effectuate the rollover in accordance with section 402 of the Code and to confirm that such plan is an eligible retirement plan within the meaning of section 402(c)(8)(B) of the Code.

(b) For purposes of Section 6.01(a), an eligible rollover distribution means any distribution of all or any portion of a Participant's benefit under another eligible retirement plan, except that an eligible rollover distribution does not include: (1) any installment payment for a period of 10 years or more, (2) any distribution made as a result of an unforeseeable emergency or other distribution which is made upon hardship of the employee, or (3) for any other distribution, the portion, if any, of the distribution that is a required minimum distribution under section 401(a)(9) of the Code. In addition, an eligible retirement plan means an individual retirement account described in section 408(a) of the Code, an individual retirement annuity described in section 408(b) of the Code, a qualified trust described in section 401(a) of the Code, an annuity plan described in section 403(a) or 403(b) of the Code, or an eligible governmental plan described in section 457(b) of the Code, that accepts the eligible rollover distribution.

(c) The Plan shall establish and maintain for the Participant a separate account for any eligible rollover distribution paid to the Plan from any eligible retirement plan that is not an eligible governmental plan under section 457(b) of the Code. In addition, the Plan shall establish and maintain for the Participant a separate account for any eligible rollover distribution paid to the Plan from any eligible retirement plan that is an eligible governmental plan under section 457(b) of the Code.

6.02 ***Plan-to-Plan Transfers to the Plan.*** At the direction of the Employer, the Administrator may permit a class of Participants who are participants in another eligible governmental plan under section 457(b) of the Code to transfer assets to the Plan as provided in this Section 6.02. Such a transfer is permitted only if the other plan provides for the direct transfer of each Participant's interest therein to the Plan. The Administrator may require in its sole discretion that the transfer be in cash or other property acceptable to the Administrator. The Administrator may require such documentation from the other plan as it deems necessary to effectuate the transfer in accordance with section 457(e)(10) of the Code and section 1.457–10(b) of the Income Tax Regulations and to confirm that the other plan is an eligible governmental plan as defined in section 1.457–2(f) of the Income Tax Regulations. The amount so transferred shall be credited to the Participant's Account Balance and shall be held, accounted for, administered and otherwise treated in the same manner as an Annual Deferral by the Participant under the Plan, except that the transferred amount shall not be considered an Annual Deferral under the Plan in determining the maximum deferral under Section 3.

6.03 ***Plan-to-Plan Transfers from the Plan.***

(a) At the direction of the Employer, the Administrator may permit a class of Participants and Beneficiaries to elect to have all or any portion of their Account Balance transferred to another eligible governmental plan within the meaning of section 457(b) of the Code and section 1.457–2(f) of the Income Tax Regulations. A transfer is permitted under this Section 6.03(a) for a Participant only if the Participant has had a Severance from Employment with the Employer and is an employee of the entity that maintains the other eligible governmental plan. Further, a transfer is permitted under this Section 6.03(a) only if the other eligible governmental plan provides for the acceptance of plan-to-plan transfers with respect to the Participants and Beneficiaries and for each Participant and Beneficiary to have an amount deferred under the other plan immediately after the transfer at least equal to the amount transferred.

(b) Upon the transfer of assets under this Section 6.03, the Plan's liability to pay benefits to the Participant or Beneficiary under this Plan shall be discharged to the extent of the amount so transferred for the Participant or Beneficiary. The Administrator may require such documentation from the receiving plan as it deems appropriate or necessary to comply with this Section 6.03 (for example, to confirm that the receiving plan is an eligible governmental plan under paragraph (a) of this Section 6.03, and to assure that the transfer is permitted under the receiving plan) or to effectuate the transfer pursuant to section 1.457–10(b) of the Income Tax Regulations.

Note: *See § 1.457–10(b)(4) of the Income Tax Regulations for rules relating to plan-to-plan transfers among eligible governmental plans of the same employer (and, for this purpose, the employer is not treated as the same employer if the participant's compensation is paid by a different entity).*

6.04 ***Permissive Service Credit Transfers.***

(a) If a Participant is also a participant in a tax-qualified defined benefit governmental plan (as defined in section 414(d) of the Code) that provides for the acceptance of plan-to-plan transfers with respect to the Participant, then the Participant may elect to have any portion of the Participant's Account Balance transferred to the defined benefit governmental plan. A transfer under this Section 6.04(a) may be made before the Participant has had a Severance from Employment.

(b) A transfer may be made under Section 6.04(a) only if the transfer is either for the purchase of permissive service credit (as defined in section 415(n)(3)(A) of the Code) under the receiving defined benefit governmental plan or a repayment to which section 415 of the Code does not apply by reason of section 415(k)(3) of the Code.

Note: *See generally § 1.457–10(b) and (e) of the Income Tax Regulations for rules relating to transfers and rollovers, including rules permitting in service transfers among eligible § 457(b) governmental plans of the same employer.*

Note: *The following definitions from Model Amendment 1 are used in this Model Amendment 6: Administrator, Account Balance, Beneficiary, Code, Employee, Employer, Participant, Plan, and Severance from Employment.*

MODEL AMENDMENT 7
Trust Funds

Section 7
Trust Funds

The following Model Amendments may be used to reflect the mandatory trust requirement applicable to eligible plans of state and local government entities under § 457(g) of the Code. Plan assets may instead be invested in whole or in part in annuity contracts or custodial accounts, in which case additional requirements will apply. See § 1.457–8 of the Income Tax Regulations.

Trust Fund. All amounts of Annual Deferrals, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights shall be held and invested in the Trust Fund in accordance with this Plan and the Trust Agreement. The Trust Fund, and any subtrust established under the Plan, shall be established pursuant to a written agreement that constitutes a valid trust under the law of [INSERT NAME OF STATE]. The Trustee shall ensure that all investments, amounts, property, and rights held under the Trust Fund are held for the exclusive benefit of Participants and their Beneficiaries. The Trust Fund shall be held in trust pursuant to the Trust Agreement for the exclusive benefit of Participants and their Beneficiaries and defraying reasonable expenses of the Plan and of the Trust Fund. It shall be impossible, prior to the satisfaction of all liabilities with respect to Participants and their Beneficiaries, for any part of the assets and income of the Trust Fund to be used for, or diverted to, purposes other than for the exclusive benefit of Participants and their Beneficiaries.

Note: See generally § 1.457–8 of the Income Tax Regulations for rules relating to funding.

Note: *The following definitions from Model Amendment 1 are used in this Model Amendment 7: Annual Deferral, Beneficiary, Code, Participant, Plan, Trust Agreement, Trust Fund, and Trustee.*

MODEL AMENDMENT 8
Miscellaneous

The following provisions are optional provisions that are not required to be adopted.

Section 8
Miscellaneous

8.1 ***Non-Assignability.*** Except as provided in Section 8.2 and 8.3, the interests of each Participant or Beneficiary under the Plan are not subject to the claims of the Participant's or Beneficiary's creditors; and neither the Participant nor any Beneficiary shall have any right to sell, assign, transfer, or otherwise convey the right to receive any payments hereunder or any interest under the Plan, which payments and interest are expressly declared to be non-assignable and non-transferable.

8.2 ***Domestic Relation Orders.*** Notwithstanding Section 8.1, if a judgment, decree or order (including approval of a property settlement agreement) that relates to the provision of child support, alimony payments, or the marital property rights of a spouse or former spouse, child, or other dependent of a Participant is made pursuant to the domestic relations law of any State ("domestic relations order"), then the amount of the Participant's Account Balance shall be paid in the manner and to the person or persons so directed in the domestic relations order. Such payment shall be made without regard to whether the Participant is eligible for a distribution of benefits under the Plan. The Administrator shall establish reasonable procedures for determining the status of any such decree or order and for effectuating distribution pursuant to the domestic relations order.

Note: *See generally § 414(p) of the Code and § 1.457–10(c) of the Income Tax Regulations for rules regarding domestic relations orders.*

8.3 ***IRS Levy.*** Notwithstanding Section 8.1, the Administrator may pay from a Participant's or Beneficiary's Account Balance the amount that the Administrator finds is lawfully demanded under a levy issued by the Internal Revenue Service with respect to that Participant or Beneficiary or is sought to be collected by the United States Government under a judgment resulting from an unpaid tax assessment against the Participant or Beneficiary.

8.4 ***Mistaken Contributions.*** If any contribution (or any portion of a contribution) is made to the Plan by a good faith mistake of fact, then within one year after the payment of the contribution, and upon receipt in good order of a proper request approved by the Administrator, the amount of the mistaken contribution (adjusted for any income or loss in value, if any, allocable thereto) shall be returned directly to the Participant or, to the extent required or permitted by the Administrator, to the Employer.

8.5 ***Payments to Minors and Incompetents.*** If a Participant or Beneficiary entitled to receive any benefits hereunder is a minor or is adjudged to be legally incapable of giving valid receipt and discharge for such benefits, or is deemed so by the Administrator, benefits will be paid to such person as the Administrator may designate for the benefit of such Participant or Beneficiary. Such payments shall be considered a payment to such Participant or Beneficiary and shall, to the extent made, be deemed a complete discharge of any liability for such payments under the Plan.

8.6 ***Procedure When Distributee Cannot Be Located.*** The Administrator shall make all reasonable attempts to determine the identity and address of a Participant or a Participant's Beneficiary entitled to benefits under the Plan. For this purpose, a reasonable attempt means (a) the mailing by certified mail of a notice to the last known address shown on [Insert Name of the Employer]'s or the Administrator's records, (b) notification sent to the Social Security Administration or the Pension Benefit Guaranty Corporation (under their program to identify payees under retirement plans), and (c) the payee has not responded within 6 months. If the Administrator is unable to locate such a person entitled to benefits hereunder, or if there has been no claim made for such benefits, the Trust Fund shall continue to hold the benefits due such person.

Note: *The following definitions from Model Amendment 1 are used in this Model Amendment 8: Administrator, Account Balance, Beneficiary, Employer, Participant, Plan, Trust Fund, and Trustee.*

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Qualified Interests

REG–163679–02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

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

DATES: Written and electronic comments must be received by October 25, 2004. Outlines of topics to be discussed at the public hearing scheduled for October 28, 2004, must be received by October 7, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–163679–02), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–163679–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–163679–02). The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Juli Ro Kim, (202) 622–3090; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 2702 provides special rules for valuing gifts in trust when the donor or an applicable family member retains an interest in the trust. If the retained interest is not a qualified interest, the retained interest is valued at zero, and the amount of the gift is the entire value of the transferred property. If the retained interest is a qualified interest, the retained interest is valued under section 7520 using prescribed actuarial tables and interest rates, and the amount of the gift is the value of the transferred property reduced by the value of the retained interest. Under section 2702(b), a qualified interest is: (1) an interest that consists of a right to receive fixed amounts payable not less frequently than annually (a qualified annuity interest); (2) an interest that consists of a right to receive amounts that are payable at least annually and are a fixed percentage of the net fair market value of the trust assets determined annually (a qualified unitrust interest); and (3) a right to receive a noncontingent remainder interest if all other interests in the trust are qualified annuity or unitrust interests (a qualified remainder interest). Under §25.2702–3(d)(3) of the Gift Tax Regulations, the qualified annuity or unitrust interest must be payable, "for the life of the term holder, for a specified term of years, or for the shorter (but not longer) of those periods." Under §25.2702–2(a)(5) the retention of a power to revoke a qualified annuity interest (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest).

These qualified interest requirements were the subject of litigation in two cases (described more fully below) before the United States Tax Court and, on appeal in one case, the Ninth Circuit Court of Appeals. These proposed regulations are being issued to clarify the existing regulations with respect to the issues raised in the cases and to revise an example in the regulations that the Tax Court held to be invalid.

Walton v. Commissioner

In *Walton v. Commissioner*, 115 T.C. 589 (2000), the Tax Court considered a situation similar to that presented in *Example 5* of §25.2702–3(e). In this example, A transfers property to an irrevocable trust, retaining the right to receive a unitrust amount for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. The example concludes that A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust amount for 10 years or until A's prior death. The example also concludes, however, that the unitrust amount payable to A's estate if A dies within the term of the trust is not a qualified interest.

In *Example 6* of §25.2702–3(e), the facts are the same as in *Example 5*, except that, if A dies within the 10-year term, the unitrust amount will be paid to A's estate for an additional 35 years. The example concludes that the result is the same as in *Example 5*; that is, A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust amount for 10 years or until A's prior death.

In *Walton*, the grantor established a grantor retained annuity trust (GRAT), pursuant to which the grantor was to receive an annuity for a term of 2 years. If the grantor died before the expiration of the 2-year term, the annuity was to be paid to the grantor's estate for the balance of the term. Upon expiration of the 2-year term, the trust corpus was to be distributed to a designated remainder beneficiary. After considering the legislative history and purpose of section 2702, the court held that *Example 5* is an unreasonable interpretation and invalid extension of section 2702. The court concluded that a retained annuity payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to expiration of the term, is a qualified interest under section 2702 for the specified term of years.

Schott v. Commissioner

As noted above, §25.2702–2(a)(5) provides that the retention of a power to revoke a qualified annuity interest (or unitrust interest) of the transferor's spouse is treated as the retention by the transferor of a qualified annuity interest (or unitrust interest). Section 25.2702–2(d)(1), *Examples 6* and *7* illustrate the application of this rule.

In *Example 6* of §25.2702–2(d)(1), A transfers property to an irrevocable trust, retaining the right to receive the income for 10 years. Upon the expiration of 10 years, the income of the trust is payable to A's spouse for 10 years, if living. Upon expiration of the spouse's interest, the trust terminates and the trust corpus is payable to A's child. A retains the right to revoke the spouse's interest. Because A has made a completed gift of the remainder interest, the transfer of property to the trust is not incomplete as to all interests in the property and section 2702 applies. A's power to revoke the spouse's term interest is treated as a retained interest for purposes of section 2702. The example concludes that, because neither one of the interests retained by A (that is, A's income interest and the spouse's revocable income interest) is a qualified interest, the amount of the gift is the fair market value of the property transferred to the trust.

In *Example 7* of §25.2702–2(d)(1), the facts are the same as in *Example 6*, except that both the term interest retained by A and the interest transferred to A's spouse (subject to A's right of revocation) are qualified annuity or unitrust interests. The example concludes that the amount of the gift is the fair market value of the property transferred to the trust reduced by the value of both A's qualified interest and the qualified interest transferred to A's spouse (subject to A's power to revoke).

In *Schott v. Commissioner*, T.C.M. 2001–110, *rev'd and remanded* 319 F.3d 1203 (9th Cir. 2003), the GRAT at issue provided for fixed annuity payments to the grantor for a 15-year term, or until the grantor's prior death. If the grantor died prior to the end of the 15-year term and the grantor's spouse survived the grantor, then the annuity was to be paid to the spouse for the balance of the 15-year term. The grantor retained the right to revoke the spouse's interest. The Tax Court, relying on its earlier opinion in *Cook v. Commissioner*, 115 T.C. 15 (2000), aff'd 269 F.3d 854 (7th Cir. 2001), concluded that the successor spousal interest was not a qualified interest, and thus, that the successor spousal interest must be valued at zero. The court noted that the term of the revocable spousal interest was contingent upon the death of the grantor and thus was not fixed and ascertainable under the governing instrument as required by §25.2702–3(d)(3). Further, because the revocable spousal interest was deemed to be an interest retained by the grantor, the possibility existed that the retained annuity interest could extend beyond the life of the term holder (the grantor) but for less than the specified 15-year term, which is not consistent with the requirement in §25.2702–3(d)(3) that the qualified annuity or unitrust interest be payable "for the life of the term holder, for a specified term of years, or for the shorter (but not longer) of those periods." The Tax Court, following its opinion in *Cook*, distinguished the *Schott* GRAT from §25.2702–2(d)(1), *Example 7*, because, in the Court's view, in *Example 7*, the spouse or the estate of the spouse would receive the annuity regardless of whether the spouse was living at the end of the grantor's initial 10-year term. Thus, the court viewed the spouse's interest in *Example 7* as a noncontingent interest for a fixed term of years. In contrast, the *Schott* spousal interest would pass to the spouse only if the grantor died within the term of the trust and the spouse was living when the grantor died.

However, on appeal, the Ninth Circuit concluded that the *Schott* spousal interest was a qualified interest. The Ninth Circuit distinguished *Cook* because the revocable spousal interest in *Cook* was also contingent upon the grantor and the spouse being married to each other at the grantor's death, which could not be accounted for by an annuity table. Further, the Ninth Circuit rejected the Commissioner's contention that a spousal interest contingent on the death of the grantor lacks the fixed term required by the regulations. Rather, the court stated that every annuity given to a person, if living, is contingent on that person's survival. The court also stated that the present value of the spouse's interest (even if dependent on the grantor's death prior to expiration of the specified term) can be ascertained using the actuarial tables.

Explanation of Provisions

Walton v. Commissioner

In Notice 2003–72, 2003–44 I.R.B. 964 (released October 15, 2003), the IRS announced that it will follow the *Walton* decision. Consistent with Notice 2003–72, the proposed regulations revise *Example 5* and *Example 6* of §25.2702–3(e) to conform to the *Walton* decision. Under the examples as revised, a unitrust amount payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to the expiration of the term, is a qualified interest for the specified term. Thus, in *Example 5*, the interest of A (and A's estate) to receive the unitrust amount for a specified term of 10 years in all events is a qualified interest. Similarly, in *Example 6*, the unitrust interest, to the extent payable to either A or A's estate for a 10-year period in all events, is a qualified interest for a 10-year term. However, in *Example 6*, the interest of A's estate to receive the unitrust amount after the 10-year period for the remaining balance of the additional 35-year term if A dies within the 10-year period, is a contingent interest that is not fixed or ascertainable at the creation of the interest and, therefore, is not a qualified interest.

The result in *Example 6*, in which only a discrete portion of the grantor's retained 35-year unitrust interest (specifically, that portion payable in all events for a 10-year term) is a qualified interest, does not change the result in *Example 1* of §25.2702–3(e). In *Example 1*, A retains the right to receive an annuity for a 10-year term, or until A's prior death. If A dies prior to the expiration of the 10-year term, the entire trust corpus reverts to A's estate. The example concludes that the estate's contingent reversion is valued at zero, notwithstanding that, economically, this reversion of the entire trust corpus includes the equivalent value of the annuity that would be payable for the balance of the 10-year term. The Tax Court in *Walton* addressed *Example 1*, noting that, in the case of a reversion, even though the equivalent of the term annuity's value would be payable to the grantor or the grantor's estate in all events, Congress was entitled to require that interests be cast in one of three specified forms to receive the favorable treatment afforded qualified interests. The Court stated ". . . the Commissioner is equally justified in assigning a zero value to reversionary interests outside the scope of the statutory definition and refusing to consider whether such interests can have the practical effect of a different form of interest not chosen by the grantor. See §25.2702–3(e), *Example (1)*, Gift Tax Regs." *Walton*, 115 T.C. at 602. Thus, in *Example 1*, the reversion, even though including the equivalent value of an annuity payable for the balance of the 10-year term, is not in a qualified form prescribed by the statute and is, therefore, not a qualified interest to any extent. On the other hand, in *Example 6* of §25.2702–3(e), the retained interest is in the form of a unitrust interest and, therefore, is a qualified interest to the extent payable to A or A's estate for a 10-year period in all events.

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The proposed regulations also clarify when a revocable spousal interest is a qualified interest.

Sections 2702(a)(3)(A)(i) and (B) confirm that the valuation rules of section 2702 do not apply to a gift that is incomplete. Section 25.2702–2(a)(5) provides a regulatory exception to this statutory rule by providing that the retention of a power to revoke a qualified annuity or unitrust interest of the transferor's spouse is a qualified interest. The annuity or unitrust interest payable to the transferor's spouse must be a qualified interest to meet this exception. Thus, the regulatory exception focuses on the spouse's annuity or unitrust interest and applies only if that interest is a qualified interest as described in §25.2702–3(d).

The references to "term holder" in §25.2702–3(d)(3) or "holder of the qualified ... interest" in §25.2702–3(b) and (c) refer to the person to whom the annuity or unitrust interest is payable during the fixed term. In the case of a revocable successor interest held by the transferor's spouse, although the spouse's interest (if qualified) is valued as a retained qualified interest of the transferor and may thus be deducted from the total value of the assets transferred in computing the taxable gift under section 2702, the spouse is the holder during the period when an interest is payable to the spouse. Thus, each qualified interest must meet the fixed duration requirements of §25.2702–3(d)(3), and each holder's separate interest must be valued as a single life annuity or unitrust interest.

In addition to the requirement that a qualified interest be for a fixed term, payment of the interest cannot be contingent on any event other than the survival of the term holder (subject to the transferor's retained right of revocation). A revocable spousal interest is contingent, and therefore not a qualified interest, if the spouse will not receive any payments if the transferor survives the fixed term during which the transferor is the holder.

Section 25.2702–2(d)(1), *Example 7*, illustrates the revocable spousal interest exception. In *Example 7*, beginning at the expiration of a 10-year term, the spouse's annuity is payable to the spouse for 10 years or until the spouse's prior death. Thus, the spouse's annuity in the example meets the requirements of §25.2702–3(d)(3), that the term of the annuity must be for either the life of the holder (the spouse), for a specified term of years, or for the shorter but not the longer of these two periods and, assuming the spouse survives until the commencement of his or her interest, the spouse will receive that interest in all events (subject to the transferor's retained right of revocation). In contrast, in *Schott*, the spouse's annuity does not meet the requirements of §25.2702–3(d)(3) because the spousal annuity is payable, if at all, only if the grantor dies prior to the termination of the term of the trust and, if payable at all, is payable for a period that depends on the length of the unexpired portion of the trust's term when the grantor dies.

The proposed regulations clarify that the revocable spousal interest exception applies only if the spouse's interest, standing alone, would constitute a qualified interest that meets the requirements of §25.2702–3(d)(3), but for the grantor's revocation power.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these proposed regulations, and because these proposed regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations will be submitted to the Small Business Administration for comment on their 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 (in the manner described in ADDRESSES of this preamble) to the IRS. The IRS and the 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 28, 2004, at 10:00 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. 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 comments by October 25, 2004, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 7, 2004.

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 proposed regulations is Juli Ro Kim, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. Other personnel from the IRS and the Treasury Department participated in their development. If you have any questions concerning these proposed regulations, please contact Ms. Kim at (202) 622–3090.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 25 is proposed to be amended as follows:

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

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

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

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

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

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

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

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

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

The additions read as follows:

§25.2702–0 Table of contents.

* * * * *

§25.2702–2 Definitions and valuation rules.

(a) * * *

(5) Holder.

* * * * *

§25.2702–3 Qualified interests.

* * * * *

(d) * * *

(2) Contingencies.

* * * * *

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

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

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

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

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

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

5. In paragraph (d)(2), introducing text, the phrase "Examples 8–10" is revised to read "Examples 6 through 8".

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

The additions read as follows:

§25.2702–2 Definitions and valuation rules.

(a) * * *

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

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

* * * * *

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

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

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

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

4. Redesignated paragraph (d)(5) is revised.

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

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

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

The revisions and additions read as follows:

§25.2702–3 Qualified interests.

* * * * *

(d) * * *

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

* * * * *

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

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

* * * * *

(e) * * *

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

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

* * * * *

Example 8. A transfers property to an irrevocable trust, retaining the right to receive an annuity equal to 6 percent of the initial net fair market value of the trust property for 10 years, or until A's prior death. At the expiration of the 10-year term, or on A's death prior to the expiration of the 10-year term, the annuity is to be paid to B, A's spouse, if then living, for 10 years or until B's prior death. A retains the right to revoke B's interest. Upon expiration of B's interest (or if A revokes B's interest, or if B predeceases A, then on the expiration of A's interest), the trust terminates and the trust corpus is payable to A's child. Because A has made a completed gift of the remainder interest, the transfer of property to the trust is not incomplete as to all interests in the property and section 2702 applies. A's annuity interest (A's right to receive the annuity for 10 years, or until A's prior death) is a retained interest that is a qualified annuity interest under paragraphs (b) and (d) of this section. In addition, because A has retained the power to revoke B's interest, B's interest is treated as an interest retained by A for purposes of section 2702. B's successive annuity interest otherwise satisfies the requirements for a qualified interest contained in paragraph (d) of this section, but for A's power to revoke. The term of B's interest is specified in the governing instrument and is fixed and ascertainable at the creation of the trust, and B's right to receive the annuity is contingent only on B's survival, and A's power to revoke. Following the expiration of A's interest, the annuity is to be paid for a 10-year term or for B's (the successor holder's) life, whichever is shorter. Accordingly, A is treated as retaining B's revocable qualified annuity interest pursuant to §25.2702–2(a)(6). Because both A's interest and B's interest are treated as qualified interests retained by A, the value of the gift is the value of the property transferred to the trust less the value of both A's qualified interest and B's qualified interest (subject to A's power to revoke), each valued as a single-life annuity. Further, if A revokes B's interest prior to the commencement of that interest, A is treated as making a completed gift at that time to A's child. The amount of the gift would be the present value of B's interest determined under section 7520 and the applicable regulations, as of the date the interest is revoked. See §25.2511–2(b) and (f).

Example 9. (i) A transfers property to an irrevocable trust, retaining the right to receive 6 percent of the initial net fair market value of the trust property for 10 years, or until A's prior death. If A survives the 10-year term, the trust terminates and the trust corpus is payable to A's child. If A dies prior to the expiration of the 10-year term, the annuity is payable to B, A's spouse, if then living, for the balance of the 10-year term, or until B's prior death. A retains the right to revoke B's interest. Upon expiration of B's interest (or upon A's death if A revokes B's interest), the trust terminates and the trust corpus is payable to A's child. As is the case in *Example 8*, A's retained annuity interest (A's right to receive the annuity for 10 years, or until A's prior death) is a qualified annuity interest under paragraphs (b) and (d) of this section. However, B's interest does not meet the requirements of paragraph (d) of this section. The term of B's annuity is not fixed and ascertainable at the creation of the trust, because it is not payable for the life of B, a specified term of years, or for the shorter of those periods. Rather, B's annuity is payable for an unspecified period that will depend upon the number of years left in the original term after A's death. Further, B's annuity is payable only if A dies prior to the expiration of the 10-year term. Thus, payment of B's annuity is not dependent solely on B's survival, but rather is dependent on A's failure to survive.

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

* * * * *

Par. 5. Section 25.2702–7 is amended to add two new sentences at the end of that section. The addition reads as follows:

§25.2702–7 Effective dates.

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

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

(Filed by the Office of the Federal Register on July 23, 2004, 8:45 a.m., and published in the issue of the Federal Register for July 26, 2004, 69 F.R. 44476)

Notice of Proposed Rulemaking

Optional 10-Year Writeoff of Certain Tax Preferences

REG–124405–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the optional 10-year writeoff of certain tax preference items under section 59(e) of the Internal Revenue Code (Code). These proposed regulations provide guidance on the time and manner of making an election under section 59(e). The regulations also provide guidance on revoking an election under section 59(e). The regulations reflect changes to the law made by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, and the Omnibus Budget Reconciliation Act of 1989.

DATES: Written or electronic comments and requests for a public hearing must be received by October 18, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–124405–03), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–124405–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–124405–03).

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, Eric B. Lee, (202) 622–3120; concerning submissions of comments and requests for a public hearing, LaNita Van Dyke, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC

20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by September 20, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.59–1(b). This collection of information is required by the IRS to verify compliance with section 59(e). This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required to obtain a benefit. The respondents are certain taxpayers who pay or incur expenditures described in section 59(e)(2).

Taxpayers provide the information on a statement that is attached to their federal income tax return for the taxable year the section 59(e) election is effective.

The estimated burden for the collection of information in §1.59–1(b) is as follows:

Estimated total annual reporting burden: 10,000 hours.

Estimated annual burden per respondent: 1 hour.

Estimated number of respondents: 10,000.

Estimated annual frequency of responses: On occasion.

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

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

Background

This document contains proposed amendments to 26 CFR part 1 under section 59(e) of the Code. Section 59(e)(1) allows taxpayers to elect to deduct any qualified expenditure ratably over a 10-year period (3-year period in the case of circulation expenditures described in section 173) beginning with the taxable year in which the expenditure was made (or, in the case of a qualified expenditure under section 263(c), over the 60-month period beginning with the month in which such expenditure was paid or incurred). Section 59(e)(2) defines *qualified expenditure* as any amount which, but for an election under section 59(e), would have been allowed as a deduction (determined without regard to section 291) for the taxable year in which paid or incurred under section 173 (relating to circulation expenditures), section 174 (relating to research and experimental expenditures), section 263(c) (relating to intangible drilling and development expenditures), section 616(a) (relating to development expenditures), or section 617(a) (relating to mining exploration expenditures).

Section 59(e)(4)(A) states that an election under section 59(e) (section 59(e) election) may be made with respect to any portion of any qualified expenditure. The legislative history of section 59(e) suggests that this allows a section 59(e) election to be made "dollar for dollar." *See* H. R. Rep. 99–426, 99th Cong., 1st Sess. 327 (1985), 1986–3 (Vol. 2) C.B. 1, 327; S. Rep. No. 99–313, 99th Cong., 2d Sess. 539 (1986), 1986–3 (Vol. 3) C.B. 1, 539.

Section 59(e)(4)(B) states that a section 59(e) election may only be revoked with the consent of the Secretary.

Provisions similar to those currently contained in section 59(e) were originally enacted as section 58(i) under the Tax Equity and Fiscal Responsibility Act of 1982, (Public Law 97–248; 96 Stat. 324). Under section 58(i)(1), the optional 10-year writeoff was available only to individuals. Section 58(i)(5)(C) directed the Secretary to promulgate regulations governing the time and manner for making an election under section 58(i) (section 58(i) election). Section 5f.0(a)(2)(i)(A) and (B) of the temporary Income Tax Regulations that were promulgated under section 58(i) required that a section 58(i) election be made by the later of the due date (including extensions) of the income tax return for the taxable year for which the election was to be effective, or April 15, 1983. T.D. 7870, 1983–1 C.B. 13 [48 FR 1486]. Section 5f.0(a)(3) provided that a section 58(i) election was made by attaching a statement to the income tax return (or amended return) for the taxable year in which the election was made. Section 5f.0 was redesignated as §301.9100–5T by T.D. 8435, 1992–2 C.B. 324 [57 FR 43893] on October 15, 1992.

Section 59(e) was enacted as part of the Tax Reform Act of 1986 (Public Law 99–514; 100 Stat. 2085) and, unlike section 58(i), is not limited to individuals. While both the Senate Finance Committee Report and the House Ways and Means Committee Report state that the time and manner of the election would be governed by regulations, Congress did not include a provision similar to former section 58(i)(5)(C) directing the Secretary to promulgate regulations governing the time and manner for making a section 59(e) election. *See* H. R. Rep. No. 99–426, 99th Cong., 1st Sess. 327 (1985), 1986–3 (Vol. 2) C.B. 1, 327; S. Rep. No. 99–313, 99th Cong., 2d Sess. 539 (1986), 1986–3 (Vol. 3) C.B. 1, 539.

Explanation of Provisions

The proposed regulations provide that a section 59(e) election shall only be made on a statement attached to the taxpayer's income tax return (or amended return) for the taxable year in which the amortization of the qualified expenditures subject to the section 59(e) election begins. A taxpayer must make a separate election for each specific activity or project with respect to which qualified expenditures are paid or incurred. The statement must be filed no later than the date prescribed by law for filing the taxpayer's original income tax return (including any extensions of time) for the taxable year in which the amortization of the qualified expenditures subject to the section 59(e) election begins. The statement must contain: (i) the taxpayer's name, address, and taxpayer identification number; (ii) the type and amount, for each activity or project, of qualified expenditures identified in section 59(e)(2) the taxpayer elects to deduct ratably over the applicable period described in section 59(e)(1); and (iii) a description of each specific activity or project to which the qualified expenditures relate. For example, if a taxpayer makes a section 59(e) election with respect to research and experimental expenditures incurred during the taxable year for three separate projects, the election statement must provide for each research project the amount of qualified expenditures subject to the election and a description of the research project. Additionally, the election must be made in terms of a specific dollar amount of qualified expenditure and cannot be made with reference to a formula.

The proposed regulations also provide that a section 59(e) election may be revoked for any project or activity only with the consent of the Commissioner and that such consent will only be granted in rare and unusual circumstances. A taxpayer must request the Commissioner's consent to revoke a section 59(e) election prior to the end of the taxable year in which the applicable amortization period described in section 59(e)(1) ends. The revocation, if granted, will be effective retroactively to the first taxable year the section 59(e) election was applicable. However, if the period of limitations for the first taxable year the section 59(e) election was applicable has expired, the revocation, if granted, will be effective in the earliest taxable year for which the period of limitations has not expired. For example, if a calendar year taxpayer makes a section 59(e) election for the taxpayer's 2003 taxable year with respect to three different projects and on June 30, 2005, requests consent to revoke the election with respect to one project, the revocation, if granted by the Commissioner prior to the expiration of the period of limitations for the taxpayer's 2003 taxable year, is effective for the taxpayer's 2003 taxable year. The amount of the qualified expenditures subject to the section 59(e) election with respect to the one project will be deductible in the taxpayer's 2003 taxable year (subject to the requirements of any other provision under the Code, regulations, or any other published guidance) and the taxpayer will be required to amend any income tax returns affected by the revocation.

The proposed regulations apply to a section 59(e) election made for a taxable year ending, or a request to revoke a section 59(e) election submitted, on or after the date the final regulations are published in the **Federal Register**. Additionally, an otherwise valid section 59(e) election filed for a tax year ending prior to the date final regulations are published in the **Federal Register** will not be challenged by the IRS merely because the election was made later than the date prescribed by law for filing the taxpayer's original income tax return (including any extensions of time) for the taxable year in which the amortization of the qualified expenditures subject to the section 59(e) begins.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the reporting burden, as discussed earlier in this preamble, is expected to be insignificant. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on 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 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 the proposed rules can be made easier to understand and comply with. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Eric B. Lee of the Office of Associate Chief Counsel (Passthroughs and Special Industries). 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:

Paragraph 1. The authority citation for part 1 reads, in part, as follows:

Authority: 26 U.S.C. 7805.

Par. 2. Section 1.59–1 is added to read as follows:

§1.59–1 Optional 10-year writeoff of certain tax preferences.

(a) *In general*. Section 59(e) allows any qualified expenditure to which an election under section 59(e) applies to be deducted ratably over the 10-year period (3-year period in the case of circulation expenditures described in section 173) beginning with the taxable year in which the expenditure was made (or, in the case of intangible drilling and development costs deductible under section 263(c), over the 60-month period beginning with the month in which the expenditure was paid or incurred).

(b) *Election* — (1) *Time and manner of election*. An election under section 59(e) shall only be made by attaching a statement to the taxpayer's income tax return (or amended return) for the taxable year in which the amortization of the qualified expenditures subject to the section 59(e) begins. A taxpayer must make a separate election for each specific activity or project with respect to which qualified expenditures are paid or incurred. The statement must be filed no later than the date prescribed by law for filing the taxpayer's original income tax return (including any extensions of time) for the taxable year in which the amortization of the qualified expenditures subject to the section 59(e) begins. Additionally, the statement must include the following information - -

(i) The taxpayer's name, address, and taxpayer identification number;

(ii) The type and amount, for each activity or project, of qualified expenditures identified in section 59(e)(2) the taxpayer elects to deduct ratably over the applicable period described in section 59(e)(1); and

(iii) A description of each specific activity or project to which the qualified expenditures identified in paragraph (b)(1)(ii) of this section relate.

(2) *Elected amount*. A taxpayer may make an election under section 59(e) with respect to any portion of any qualified expenditure paid or incurred by the taxpayer in the taxable year to which the election applies. An election under section 59(e) must be for a specific dollar amount and the amount subject to an election under section 59(e) may not be made by reference to a formula.

(c) *Revocation* — (1) *In general*. An election under section 59(e) may be revoked for any project or activity only with the consent of the Commissioner. Such consent will only be granted in rare and unusual circumstances. The revocation, if granted, will be effective in the first taxable year in which the section 59(e) election was applicable. However, if the period of limitations for the first taxable year the section 59(e) election was applicable has expired, the revocation, if granted, will be effective in the earliest taxable year for which the period of limitations has not expired.

(2) *Time and manner for requesting consent*. A taxpayer requesting the Commissioner's consent to revoke a section 59(e) election must submit the request prior to the end of the taxable year the applicable amortization period described in section 59(e)(1) ends. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request.

(3) *Information to be provided*. A request to revoke a section 59(e) election must contain all of the information necessary to support why the Commissioner's consent should be granted and must specify the project activity to which the revocation shall apply.

(4) *Treatment of unamortized costs*. The unamortized balance of the qualified expenditures subject to the revoked section 59(e) election as of the first day of the taxable year the revocation is effective is deductible in the year the revocation is effective (subject to the requirements of any other provision under the Code, regulations, or any other published guidance) and the taxpayer will be required to amend any income tax returns affected by the revocation.

(d) *Effective date*. These regulations apply to a section 59(e) election made for a taxable year ending, or a request to revoke a section 59(e) election submitted, on or after the date the final regulations are published in the **Federal Register**.

Mark Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 19, 2004, 8:45 a.m., and published in the issue of the Federal Register for July 20, 2004, 69 F.R. 43367)

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

Announcement 2004-63

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

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

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

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been disbarred from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Banister, Joseph R.	San Jose, CA	CPA	June 25, 2004

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

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been placed under suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Stukes, Donald A.	Pound Ridge, NY	CPA	May 13, 2004 to May 11, 2005
Moore, Earl	Riverview, FL	CPA	March 26, 2004 to March 24, 2006

Consent Suspensions From Practice Before the Internal Revenue Service

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

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

Name	Address	Designation	Date of Suspension
Bell, Don W.	Grand Junction, CO	Enrolled Agent	Indefinite from April 1, 2004
Lentz, Carole A.	Mastic, NY	Enrolled Agent	Indefinite from April 23, 2004
Cummiskey Jr., Edward R.	Warwick, NY	Enrolled Agent	Indefinite from April 23, 2004

Name	Address	Designation	Date of Suspension
Goble, Dennis R.	Valparaiso, IN	CPA	Indefinite from April 26, 2004
Grant, Elaine C.	Woodway, WA	Enrolled Agent	May 1, 2004 to October 31, 2004
Rivera, Eduardo M.	Torrence, CA	Attorney	May 1, 2004 to October 29, 2006
Masengale, Thomas J.	Indianapolis, IN	Enrolled Agent	Indefinite from May 1, 2004
Cohick, Jeffrey S.	Newville, PA	Enrolled Agent	May 1, 2004 to October 30, 2004
Bach, Royce E.	Deer Park, TX	Enrolled Agent	Indefinite from May 27, 2004
McMillin, Juanell	Austin, TX	Enrolled Agent	Indefinite from May 28, 2004
Silva, Hesmeregildo V.	Livermore, CA	Enrolled Agent	Indefinite from May 28, 2004
Grossman, Richard	Durham, NC	Attorney	Indefinite from June 1, 2004
Schnieders, Joseph A.	St. Louis, MO	Enrolled Agent	Indefinite from June 1, 2004
Rahn, Miriam C.	Hutchinson, MN	Enrolled Agent	Indefinite from June 8, 2004
Tarantur, Dale B.	Glenview, IL	CPA	Indefinite from June 15, 2004
Derby, Mark	West Newton, MA	CPA	Indefinite from June 15, 2004
Miller, Winfred J.	Harrisonburg, VA	CPA	Indefinite from June 30, 2004
Croom, John A.	Austin, TX	CPA	Indefinite from July 1, 2004

Name	Address	Designation	Date of Suspension
Dion, Paul	Middletown, RI	CPA	Indefinite from July 8, 2004
Todd, Debra R.	Leander, TX	Enrolled Agent	Indefinite from August 30, 2004

Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

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

Name	Address	Designation	Date of Suspension
Somerville, Sally L.	Havre de Grace, MD	Attorney	Indefinite from May 3, 2004
Simon, Laurence M.	Englishtown, NJ	CPA	Indefinite from May 10, 2004
Taylor, Joelle T.	Carolina Beach, NC	CPA	Indefinite from May 10, 2004
Becker, Joseph C.	Austin, TX	CPA	Indefinite from May 10, 2004
Maffongelli Jr., Joseph	Montclair, NJ	Attorney	Indefinite from May 10, 2004
Lence, John A.	Kalispell, MT	CPA	Indefinite from May 21, 2004
McWade, Kenneth W.	Kaliua, HI	Attorney	Indefinite from June 9, 2004
Sims, William A.	Sausalito, CA	Attorney	Indefinite from June 9, 2004
Sommer, Peter J.	Baltimore, MD	Attorney	Indefinite from June 21, 2004

Name	Address	Designation	Date of Suspension
Eisenberg, Alan D.	Whitefish Bay, WI	Attorney	Indefinite from June 21, 2004
Litwin, Martin E.	Highland Park, IL	Attorney	Indefinite from June 21, 2004
Kiernat, Bruce E.	St. Paul, MN	Attorney	Indefinite from July 1, 2004

Resignations of Enrolled Agents

Under Title 31, Code of Federal Regulations, Part 10, an enrolled agent, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her resignation as an enrolled agent. The Director, Office of Professional Responsibility, in his discretion, may accept the offered resignation.

The Director, Office of Professional Responsibility, has accepted offers of resignation as an enrolled agent from the following individuals:

Name	Address	Date of Resignation
Murphy, Claire A.	Viera, FL	May 10, 2004
Murphy, John W.	Viera, FL	May 10, 2004

Censure Issued by Consent

Under Title 31, Code of Federal Regulations, Part 10, in lieu of a proceeding being instituted or continued, an attorney, certified public accountant, enrolled agent, or enrolled actuary, may offer his or her consent to the issuance of a censure. Censure is a public reprimand.

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

Name	Address	Designation	Date of Censure
Clifton, Michael J.	Augusta, KS	CPA	May 12, 2004
Flaherty, Patrick J.	Traverse City, MI	CPA	May 19, 2004
Monroy, Frances	Petaluma, CA	Enrolled Agent	May 27, 2004
Pearson, Michael N.	Houston, TX	Enrolled Agent	June 7, 2004

Partial Withdrawal of Proposed Regulations Relating to the Application of Section 904 to Income Subject to Separate Limitations and Computation of Deemed-Paid Credit Under Section 902

Announcement 2004–64

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws a portion of a notice of proposed rulemaking (REG–104683–00, 2001–1 C.B. 407) published on January 3, 2001, relating to the application of the foreign tax credit limitation under section 904 and the deemed-paid credit under section 902.

DATES: The withdrawal of proposed §§1.902–0, 1.902–1 and 1.904–4(g) is made on July 20, 2004.

FOR FURTHER INFORMATION CONTACT: Bethany A. Ingwalson, (202) 622–3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 319) a notice of proposed rulemaking (REG–104683–00) providing guidance with respect to the application of sections 902 and 904. Written comments were received and a public hearing on the proposed regulations was held on April 26, 2001. After consideration of the comments received, the Treasury Department and the IRS are withdrawing the portions of the proposed regulations that would have amended §§1.902–1 and 1.904–4(g). The amendments to §1.902–1 would have terminated the pooling of a foreign corporation's post–1986 undistributed earnings and foreign income taxes if the ownership requirements of section 902(c)(3)(B) were not met as of the end of any taxable year. The amendments to §1.904–4(g) would have disallowed look-through treatment for a dividend paid by a CFC or noncontrolled section 902 corporation out of E&P accumulated while the corporation was a look-through entity (*i.e.*, the corporation was a CFC or, for tax years beginning after December 31, 2002, a noncontrolled section 902 corporation) if paid after an intervening period during which the corporation was a non-look-through entity (*i.e.*, a less-than 10%-U.S.-owned corporation or, for tax years beginning on or before December 31, 2002, a noncontrolled section 902 corporation).

Final regulations (T.D. 9141) adopting the remaining portions of the proposed regulations are being published in this issue of the Bulletin. See the preamble to the final regulations for a discussion of the reasons §§1.902–1 and 1.904–4(g) are being withdrawn.

Drafting Information

The principal author of this withdrawal notice is Bethany A. Ingwalson, Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in its development.

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Partial Withdrawal of a Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, §§1.902–0, 1.902–1 and 1.904–4(g) of the notice of proposed rulemaking published in the **Federal Register** (66 FR 319) on January 3, 2001, are withdrawn.

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

(Filed by the Office of the Federal Register on July 19, 2004, 8:45 a.m., and published in the issue of the Federal Register for July 20, 2004, 69 F.R. 43366)

Foundations Status of Certain Organizations

Announcement 2004–66

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

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

3 Eagle Ministries I C N, Salt Lake City, UT
225th West Tenant Association, Inc., Long Beach, CA
Academy of Missouri Educational Network of Graduate Dogs, Inc., Warrenton, MO
Accesibility Housing Foundation, Inc., Los Angeles, CA
Add Advocate, Albuquerque, NM
Adopt-A-Village, Inc., Carbondale, IL
Afghan Studies Council, Orange, CA
African-American Policy Council, Laurens, SC
AHEPA Family Charities of the Palm Beaches Foundation, Inc., West Palm Beach, FL
Alabama Health Care Hall of Fame and Health Care Heritage Museum, Birmingham, AL
Alliance for Support of American Legion Baseball in Anchorage, Inc., Anchorage, AK
Alone All Little Ones Need Everyone, Bellevue, CO
Alum Rock Youth Soccer League, San Jose, CA
American Devoting Volunteers for International Culture and Education, Fort Lauderdale, FL
American Friends of Moreshet Menaxh Menachem, Brooklyn, NY
American Friends of Shalom Beinenu, Herzliya, Israel
American Friends of the Amuta for Renewal and Advancement of Democracy, Inc., New York, NY
American Indo Welfare Society, Houston, TX
Amphibious Ships Museum, Inc., Omaha, NE

Anaheim General Hospital Auxiliary, Anaheim, CA
Anaheim Public Library Foundation, Anaheim, CA
Anchorage Urban League, Anchorage, AK
Andmar Residential Homes, Inc., Rancho Cucamonga, CA
Angel Nutritional Training & Services, Houston, TX
Animal Welfare Rescue and Educational Foundation, Inc., Leesburg, VA
Appalachian Media Outreach, East Bernstadt, KY
Art Project, Inc., La Jolla, CA
Aspen-Olive Community Development Corp., Philadelphia, PA
Aspiring Angels, Temecula, CA
Association for Women in Sales & Marketing, San Diego, CA
Athletic Achievement & Development Academy, Austin, TX
Athletic Scholastic Scholarship Incentive Strategic Team, Inc., Irvine, CA
Attachment Disorder Help & Resource Network, Inc., Oneonta, NY
Aviation Community Advisory & New Development Organization, Inc., Fortuna, CA
Banyan Fund, Washington, DC
Baptist Volunteer Mission Fund, Inc., Portland, OR
Barr-Reeve Band Boosters Organization, Montgomery, IN
Bascom Volunteer Fire Department, Bascom, FL
Bay Lakes Council Troop 51, Little Chute, WI
Believers Life of Faith Ministries, Inc., Lexington Park, MD
Bellas Artes Mexicanas, Omaha, NE
Best of the Batch Foundation, Cleveland, OH
Biblical Literacy Ministries, Norton, MA
Bio Park Foundation, Inc., Tucson, AZ
Biochemical Research Foundation, Inc., Aspen, CO
Black Women on the Move, Akron, OH
Bloomington Save Our Youth, Rialto, CA
Bobs Ctvrtlik Give Back Foundation, Encinitas, CA
Body Building Ministries, Inc., Clever, MO
Brazos Performing Arts Foundation, Waco, TX
Bridges Medical Services Foundation, Inc., Ada, MN
Bright Hope Hospice, Inc., Whitehall, PA
Brightwood Community Construction and Training Corporation, Washington, DC
Broadcasting for the Challenged, Inc., Memphis, TN
Bronx Arts Cultural Center, Inc., Bronx, NY
Brotherhood, Inc., Decatur, GA
Brothers of San Diego, Inc., San Diego, CA
Building Block Ministries, Inc., Somerset, KY
Building Peaceful Communities, San Pedro, CA
C is for Cat, Long Beach, CA
Cadbury at Lewes, Inc., Cherry Hill, NJ
California Consumer Council, San Diego, CA
Canton Preservation, Inc., Canton, GA
Cardiac Monitor Tech Association, Lawton, OK
Carnaval Independencia Centro America Y Mexico, Inc., Miami, FL
Casa De La Familia, Los Angeles, CA
Castle Park Garden Housing Association, Chula Vista, CA
Cave Springs Christian Retreat, Inc., Miami, OK
Center for Development and Peoples League, Fords, NJ
Central City Community Neighborhood Development Corporation, Inc., Gloucester, MA
Cheries Day Care Learning Center, Baker, LA
Chibb Foundation, McLean, VA
Childrens Community of Caring, Inc., Van Nuys, CA
Childrens Legal Clinic, Newport Beach, CA
Childrens Ministries of America, Lombard, IL
Childrens Orphanage, Inc., Long Beach, CA
Chowa Community Service, Inc., Loma Linda, CA
Christ Jesus Ministry, Inc., Temple Hills, MD
Citizens for Community Values of Spokane, Moses Lake, WA
Civil War Landscapes Association, Chicago, IL
Classic Charities of Orange County, Newport Beach, CA
Cleveland Association of Black Storytellers, Inc., Shaker Heights, OH
Coachella Valley Helping Hands, Inc., Indio, CA
Coconut Grove Coral Gables Writers, Inc., Miami, FL
Commonwealth International Foundation, Issaquah, WA
Community Counseling Center, Stevens Point, WI
Community Economic Empowerment Corporation, Louisville, KY
Community Improvement Corporation of Euclid, Euclid, OH
Community Relief Foundation, Jackson, MS
Community Resource Institute, Inc., Phoenix, AZ
Community Uplift, Inc., N. Wales, PA
Comstock Ministries, Inc., Stockton, CA
Concerned Citizens of the Pass for a Clean Environment, Inc., Beaumont, CA
Conservators Center, Inc., Mebane, NC
Consumer Business Network, Inc., Newport Beach, CA
Coral Cay Conservation Foundation, Tequesta, FL
Covenant Educational Fellowship, Inc., Raleigh, NC
Cowboys Dreams, East Dundee, IL
Crafty Chair-Ubs, Inc., Old Hickory, TN
Crandall Citizens Police Academy Alumni Association, Crandall, TX
Creative Collective Arts Center, Inc., Philadelphia, PA
Crestline Italian American Association, Crestline, OH
Cross Enterprise Organization, Inc., Romulus, MI
CSBA Candlelighters, Inc., Augusta, GA
D S Soccer World, San Diego, CA
Dallas County R-1 Alumni Association, Inc., Buffalo, MO
Day Labor Program of San Francisco, San Francisco, CA
Dayton Chapter Southern Christian Leadership Conference FDTN, Inc., Dayton, OH
Debbie Gregory Breast Cancer Foundation, Loves Park, IL
Dekalb ICC, Inc., Decatur, GA
Denver Press Club, Denver, CO
Depiction Bible Evangelism, Honolulu, HI
Developmental Disabilities Foundation of California, Inc., Palm Desert, CA
Dirtbags Baseball Association, Los Alamitos, CA
Disciples of Faith, Inc., Timonium, MD
Domingo Development, Inc., Miami, FL
Dr. Haing S. Ngor Memorial Foundation, Inc., Long Beach, CA
Drc Sannam Forum, Inc., Oradell, NJ

Eadv, Inc., Canfield, OH
Eagles Wings Ministries, Upland, CA
Earth Keep, Manassas, VA
East Texas Symphonic Band, Inc., Longview, TX
Ebie Cameroon American Laboratory School, Chicago, IL
Eco Psy Institute, Sedona, AZ
Economic Development Community Corporation, Hearne, TX
Ed Kotler Leukemia Research Foundation, Glencoe, IL
Education Consulting Group, Inc., Boston, MA
Elder Housing Options, Inc., Coral Gables, FL
Environmental Perspectives International, Chula Vista, CA
Everymay Society, Washington, DC
Excellence in Action, Inc., Boulder, CO
Extra Mile of Monroe County, Madisonville, TN
Fair Haven Homeless Foundation, Shreveport, LA
Family Link Treatment Services, Inc., Austin, TX
Fast and Indispensable Temporary Help Faith Ministries, Inc., Mesa, AZ
Fathers Project, Berkeley, CA
Filling the Gap, Inc., Debary, FL
Fins for Freedom Foundation, Friday Harbor, WA
Firelands Positive People High School Positive Living Award, Inc., Huron, OH
First Richmond Morrow Housing, Inc., V, Mansfield, OH
First Richmond Morrow Housing, Inc., VI, Mansfield, OH
Flaming Fire Ministries, Incorporated, Dallas, TX
Flowing Waters Ministry, Inc., Fort McCoy, FL
Foundation for Animation and Creative Technology, San Diego, CA
Foundation for the Preservation of Indigenous Music, Plantation, FL
Fourth Alabama Infantry Regiment CSA, Inc., Vestavia, AL
Fred Biangardi Memorial Baseball Scholarship Fund, Islip, NY
Friends and Helpers Foundation, Encino, CA
Friends Help Friends, Inc., – Ezras Rayim, Spring Valley, NY
Friends of Hawaii's Urban Forests, Kapolei, HI
FSR California Affordable Housing Foundation, Newport Beach, CA
Gaius Christian Ministries, Farmington Hills, MI
Gangbusters International, Inc., Seal Beach, CA
Georgia Hispanic Voter Registration Campaign, Atlanta, GA
Geric Organization, Cleveland, OH
Gift From God, Cherry Hill, NJ
Gift of Faith, Mt. Laurel, NJ
Gods Gang Ministries, Inc., Dana Point, CA
Gospel Messenger Ministries, Yucaipa, CA
Gracious Living, Yreka, CA
Grand Chapter of Florida Order of the Eastern Star Charitable, Tampa, FL
Grand River Improvement Association, Detroit, MI
Great Lakes Freedom Foundation, Fremont, OH
Greater Bridgeport Exchange Club Services for Children, Inc., Trumbull, CT
Greater Cleveland Writing Center, Lakewood, OH
Greater Unity Economic Development Training Center, Toledo, OH
Green City Community Betterment Association, Green City, MO
Green-Quincy Housing Development Fund, New York, NY
Grossmont High School Educational Foundation, La Mesa, CA
Haitian American Community, Trenton, NJ
Hands Job Placement Service for the Deaf, Temecula, CA
Harbor Area Youth Assistance, Inc., Long Beach, CA
Harbor Community Health Center, Los Angeles, CA
Harbor Youth Activity Center, San Pedro, CA
Hardees Employers Hurricane Fund, Anaheim, CA
Harold Dutton Sr. Challenged Condition Youth Center, Houston, TX
Harrison County Drug Resistance Advisory Committee, Bethany, MO
Harrison County Korean War Memorial Association, Inc., Cynthiana, KY
Havasu Childrens Service, Calexico, CA
Health is Wealth Foundation, Inc., Edgewood, MD
Help Our World, Costa Mesa, CA
His Hands Extended Ministries International, Chino, CA
Hollywood Comedy Club, Laguna Niguel, CA
Homestretch of San Diego, Inc., San Diego, CA
Hope House for Teens, Norcross, GA
Hope Human Resources, Inc., Detroit, MI
Horus Health Services, Los Angeles, CA
Housing Made Affordable Corporation, Atlanta, GA
Housing Outreach, Huntington Beach, CA
Huapu International Cultural & Educational Exchange Fund, San Francisco, CA
Humpty Molar Health Foundation, Inc., Cleveland Heights, OH
Hunter Coleman Holland Foundation for Chronic Granulomauos Disease I, Edgewater, FL
In His Steps Ministries, Kannapolis, NC
International Adoption Agency, Inc., North Miami Beach, FL
International Biblical Learning Center, Inc., Laguna Hills, CA
International Council for Global Health Progress, Inc., New York, NY
International Foundation Christ for the Nation, San Bruno, CA
International Foundation for Applied Research in the Natural Sciences, Newport Beach, CA
International Professional Association for AIDS and Children's Charities, Inc., Altamonte Springs, FL
Jackson River Restoration Foundation, Inc., Warm Springs, VA
JCS Foundation, Calabasas, CA
Jerome G. Little Manor, Inc., Yazoo City, MS
Josef House, Houston, TX
Joshua Achievement Center, Philadelphia, PA
Joshua Foundation, Perris, CA
Joy to the Children, Inc., Fernandina, FL
K-9 Rescue, Lockhart, TX
K. D. Wallace Ministries, Inc., Knoxville, TN
Kalhan Foundation, Pepper Pike, OH
Kensett Area Museum Park and Recreation Corporation, Kensett, AR
Kids N Moms House, San Francisco, CA
Kids Voting El Paso, Inc., El Paso, TX
Kids Youth Mentorship Services, Moreno Valley, CA
Kimborough for Kids, Inc., Cincinnati, OH
King Solomon Education Foundation, Encino, CA

Ko Young Ok & Ko Won Sang, Garden Grove, CA
Korean-American Inventors Association, Long Beach, CA
Kylies Project, Bellingham, WA
La-Van Hawkins Foundation, Inc., Baltimore, MD
Lake Charles Community Outreach Project, Lake Charles, LA
Lane County Toys for Tots, Eugene, OR
Langstons Personal Care Home, Inc., Canton, GA
Lasdoc Housing Development, Inc., San Juan Capistrano, CA
Latin American Library Support, Inc., West Newbury, MA
Launch Productions, Cincinnati, OH
LearningQuest, Inc., Roslyn Heights, NY
Liaison for Liberty Foundation, Colorado Springs, CO
Liberty Outreach, Inc., Toledo, OH
Lifelink – International Orphans Adoption Services, San Diego, CA
Lighthouse Project, Columbus, OH
Lima Blues Society, Cridersville, OH
Little Big Bang, Inc., Baltimore, MD
Little Tumbleweeds, Inc., Cloves, NM
Living Stream, Inc., Toledo, OH
Lord is My Shepherd Outreach Ministries, Inc., Columbus, OH
Lords Farm, Inc., Archbold, OH
Lotus Community Services, Inc., Redondo Beach, CA
Lozano Family Ministries, Inc., San Diego, CA
Lucille Roberts Foundation for Women, Inc., New York, NY
Main Street 25, Inc., Richmond, VA
Malcom X Library Advisory Council, San Diego, CA
Manchester Suburban Youth Football Organization, N. Canton, OH
Manhasset Bay Sailing Foundation, Inc., Port Washington, NY
Marion County Historical Society, Lebanon, KY
Martin Luther King Jr. Scholarship Committee, Inc., Ft. Meade, FL
Mastiff Association for the Human, Springfield, VA
Mayan Esteem Project, San Antonio, TX
McLean Christian Counseling Center, McLean, VA
McPherson County Critical Incident Stress Management Team, Inc., McPherson, KS
Medical Services Foundation International, Prospect Heights, IL
Mens of America Association, Vista, CA
Metro Network Speech Language Committee, Denver, CO
Middle Passage Foundation, Incorporated, Silver Spring, MD
Ministerio Nueva Creation, New York, NY
Ministry Business Consultants, Dauphin, PA
Miracles Ministries Outreach, Inc., Bloomfield Hills, MI
Momentum Health Alliance, Minneapolis, MN
Montrose Golden Hope Center of Montrose, Colorado, Montrose, CO
Moonrise Foundation and Retreat Center, Rockville, MD
Motivated Museum Members, Laguna Beach, CA
Mt. Zion Economic Development Corporation, Ontario, CA
Multilateral Middle East Initiative, Bloomington, MN
Muncie Center for the Arts, Inc., Muncie, IN
My Father's Business, Inc., Las Vegas, NV
My Kids School Kids, Inc., Windemere, FL
My Officer Needs Assistance, Lombard, IL
Nathan Kim Mission, Torrance, CA
National Charitable Fund, Inc., Cleveland, OH
Nehemiah Ministries, Inc., Canton, OH
Ness Counseling Center, Inc., Los Angeles, CA
Neuro-Science Research Foundation, Inc., Tulsa, OK
New Advent, Inc., Arvada, CO
New Creations Gospel Quartet, Inc., Upland, CA
New Hope Ministries of San Diego, Inc., San Diego, CA
New Horizons Community Development Corp., Palm Springs, CA
New Life Community Outreach Ministries, Inc., Hawkinsville, GA
Next Step Ministries, Inc., Louisville, KY
Nolan Willis Cardiac Foundation, Inc., Miami, FL
North Shore Environmental Alliance, Inc., Manhasset, NY
Norton Sound Fund, Anchorage, AK
Oakdale Dixie Youth, Inc., Oakdale, LA
Oglesby Community Action Corporation, Oglesby, TX
Okaloosa Walton Library Coalition, Inc., Niceville, FL
Old Town Volunteer Department, Jonesborough, TN
Open Mind, Inc., East St. Louis, IL
Opportunity for Youth, Desoto, TX
Opportunity Foundation, Salt Lake City, UT
Orange County Jet Sports Club, Irvine, CA
Outdoor Adventures for Women Foundation, Chamberlain, SD
Outreach Community Development Center, Inc., Stuttgart, AR
P W C People Who Care, Trenton, TN
PACA, Cincinnati, OH
Painted Sky, Inc., Portland, OR
Palm Harbor Library Endowment Foundation, Inc., Palm Harbor, FL
Parents Association of the Franklin & Marshall College Childrens Center, Lancaster, PA
Parker Kane Foundation, Inc., Lilburn, GA
People Helping People, Oceanside, CA
Perris Valley Boxing Club, Perris, CA
Perris Valley Seniors, Inc., Perris, CA
Peter Haight Foundation, Sylmar, CA
Phyllis Sweeney Encouragement Factor, Fallbrook, CA
Pipe Creek Emergency Medical Support Team, Inc., Pipe Creek, TX
Pipe Dreams, Kansas City, MO
Plano West Quarterback Club, Inc., Plano, TX
Pleasant Valley Softball Association, Bettendorf, IA
Pond Creek Fire EMS Association, Pond Creek, OK
Positive Phase 1, Inc., Philadelphia, PA
Proclaim Christ, Inc., Washington, DC
Professional Womens Golf Club Foundation, Albuquerque, NM
Progressive People Developers, Inc., Minneapolis, MN
Psaltys Kids Ministries International, Coto De Casa, CA
Reaching Potentials of South Carolina, Inc., Hilton Head Island, SC
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Residential Energy Efficiency Clearing House, Inc., Yorba Linda, CA
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River of Light Enterprise, Inc., Brighton, CO
Riviera Community Development Outreach Program, Inc., Riviera Beach, FL

Rock Wall Foundation, Inc., Dallas, TX
Ross Good Samaritan Association, Westminster, CA
Saddleback Valley Charity Cup Tournament, Mission Viejo, CA
Safe & Secure Home, Inc., Macedonia, OH
Safe Haven Family Home, East Orange, NJ
Samaria Mission Center, Inc., Tampa, FL
San Diego Comprehensive Oral Health Center, Inc., San Diego, CA
San Diego County Youth Leadership Council, El Cajon, CA
San Diego Liason League, Santee, CA
San Diego Now Outreach Fund, Inc., San Diego, CA
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Sanders Enterprise Community Development, Wilson, NC
Schoolhouse Foundation of New York, New York, NY
Scott Elderly Housing Development Corporation, Lafayette, LA
SD Gridiron Association, Austin, TX
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Second Chance Club, Thibodeaux, LA
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Securities Association of Virginia Foundation, Inc., Richmond, VA
Seed Time Harvest Ministries, Inc., Natchitoches, LA
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Set Roots, Santa Ana, CA
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Snow Hill Ministries, Mt. Pleasant, TX
Social Services of Southeast Louisiana, Inc., Gretna, LA
Somali Youth and Education Center, Columbus, OH
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Urban Associates, Inc., Toms River, NJ
US Friends of Lower Canada College, Inc., Montreal Quebec, Canada
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Valdosta City Schools Foundation, Valdosta, GA
Veterans Aimed Towards Awareness, Inc., Middletown, DE
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Vocational Support Services, Inc., Wallace, ID
Walters Childrens Charities Classic, Riverside, CA
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Wesley Stage Park, Inc., Memphis, TN
Western Son Academy, West Covina, CA
Widgeon Habitat Foundation, Chicago, IL
Willing Hands Missions, Colton, CA
Willmarth and Marion Paine Scholarship Fund, Toledo, CA
Wisdom Temple, New York, NY
Wishing Well Foundation, Cleveland, OH
Wolf Institute, Norman, OK
Women of Praise Ministries, Sacramento, CA
Womens Ocean Racing Sailing Association, Huntington Beach, CA
World Dental Outreach, Inc., Smyrna, GA
Xpressions of Youth Cultural Art Center, Fontana, CA

Yad Erfat Letinokot, Inc., Brooklyn, NY
Young Mother of Today Maternity Home – Shelter, Wichita, KS
Youth Programs Collaborative, Memphis, TN
Zion Human Resource Economic Development Corporation, New Orleans, LA
Zoe, Federal Way, WA

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

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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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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