Internal Revenue
bulletin

Bulletin No. 2007-21
May 21, 2007

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2007–24, page 1282.

Section 1035; certain exchanges of insurance policies. A taxpayer's receipt of a check issued by an insurance company under a non-qualified annuity contract is treated as a taxable distribution, even if the check is endorsed to a second insurance company for the purchase of a second annuity. The transaction is not characterized as a tax-free exchange under section 1035(a)(3) of the Code unless there is a direct exchange or assignment of the original contract.

Rev. Rul. 2007–30, page 1277.

Income attributable to domestic production activities; qualifying in-kind partnerships. This ruling provides that a partnership engaged in the extraction and processing of minerals within the United States is a qualifying in-kind partnership for purposes of section 199 of the Code. Each partner of a qualifying in-kind partnership is treated as having manufactured, produced, grown, or extracted (MPGE) property MPGE by the partnership that is distributed to that partner.

Rev. Rul. 2007–31, page 1275.

Contributions to the capital of a corporation; nonshareholder contributions. This ruling provides that payments received by a corporation under the federal universal service support mechanisms do not represent a nonshareholder contribution to capital under section 118(a) of the Code. The federal universal service support mechanisms are funded by contributions from telecommunications carriers. Telecommunications carriers receive support payments to provide discounted telecommunications services or telecommunication services in high cost areas.

Rev. Rul. 2007–32, page 1278.

Accrual of interest. This ruling requires an accrual method bank with a reasonable expectancy of receiving future payments on a loan to include accrued interest (determined under regulations section 1.446–2(a)(2)) in gross income for the taxable year in which the right to receive the interest becomes fixed, notwithstanding bank regulatory rules that prevent accrual of the interest for regulatory purposes. The ruling also provides guidance as to the period in which a bank that has elected the conformity method of accounting under regulations section 1.166–2(d)(3) can treat uncollected interest as worthless. Rev. Rul. 81–18 distinguished.

Rev. Rul. 2007–33, page 1281.

Real estate investment trust (REIT) foreign currency. This ruling provides that section 988 gain that is recognized by a REIT will be qualifying income under section 856(c)(2) or (3) of the Code to the extent that the underlying income so qualifies.

Notice 2007–40, page 1284.

Renewable electricity production, refined coal production, and Indian coal production; calendar year 2007 inflation adjustment factors and reference prices. This notice announces the calendar year 2007 inflation adjustment factors and reference prices for the renewable electricity production credit, refined coal production credit, and Indian coal production credit under section 45 of the Code.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Notice 2007–41, page 1287.
The Department of Treasury and the Service invite public comments on recommendations for items that should be included on the 2007–2008 Guidance Priority List. Taxpayers may submit recommendations for guidance at any time during the year. Recommendations submitted by May 31, 2007, will be reviewed for possible inclusion on the original 2007–2008 Guidance Priority List. Recommendations received after May 31, 2007, will be reviewed for inclusion in the next periodic update.

Notice 2007–42, page 1288.
This notice provides guidance to real estate investment trusts (REITs) concerning the circumstances under which section 856(c)(2) or (3) of the Code characterizes section 987 gain as qualifying income for REIT qualification.

Rev. Proc. 2007–33, page 1289.
This document provides the exclusive procedures under which a bank may change its method of accounting for uncollected interest to an elective safe harbor method based on the bank's collection experience. Rev. Proc. 2002–9 modified and amplified.

EMPLOYEE PLANS

Notice 2007–33, page 1284.
Weighted average interest rate update; corporate bond indices; 30-year Treasury securities. The weighted average interest rate for May 2007 and the resulting permissible range of interest rates used to calculate current liability and to determine the required contribution are set forth.

Notice 2007–41, page 1287.
The Department of Treasury and the Service invite public comments on recommendations for items that should be included on the 2007–2008 Guidance Priority List. Taxpayers may submit recommendations for guidance at any time during the year. Recommendations submitted by May 31, 2007, will be reviewed for possible inclusion on the original 2007–2008 Guidance Priority List. Recommendations received after May 31, 2007, will be reviewed for inclusion in the next periodic update.

EXEMPT ORGANIZATIONS

Notice 2007–41, page 1287.
The Department of Treasury and the Service invite public comments on recommendations for items that should be included on the 2007–2008 Guidance Priority List. Taxpayers may submit recommendations for guidance at any time during the year. Recommendations submitted by May 31, 2007, will be reviewed for possible inclusion on the original 2007–2008 Guidance Priority List. Recommendations received after May 31, 2007, will be reviewed for inclusion in the next periodic update.

ESTATE TAX

REG–143316–03, page 1292.
Proposed regulations under section 2053 of the Code provide guidance to determine the amount deductible from a decedent's gross estate for claims against the estate under section 2053(a)(3). Under these regulations, the amount deductible is generally the amount actually paid in satisfaction of a legitimate claim. The regulations provide special rules for potential claims, contested claims, claims against multiple parties, claims by family members and related entities, unenforceable claims, and recurring payments. A public hearing is scheduled for August 6, 2007.

Notice 2007–41, page 1287.
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GIFT TAX

Notice 2007–41, page 1287.
The Department of Treasury and the Service invite public comments on recommendations for items that should be included on the 2007–2008 Guidance Priority List. Taxpayers may submit recommendations for guidance at any time during the year. Recommendations submitted by May 31, 2007, will be reviewed for possible inclusion on the original 2007–2008 Guidance Priority List. Recommendations received after May 31, 2007, will be reviewed for inclusion in the next periodic update.

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EMPLOYMENT TAX

Notice 2007–41, page 1287.
The Department of Treasury and the Service invite public comments on recommendations for items that should be included on the 2007–2008 Guidance Priority List. Taxpayers may submit recommendations for guidance at any time during the year. Recommendations submitted by May 31, 2007, will be reviewed for possible inclusion on the original 2007–2008 Guidance Priority List. Recommendations received after May 31, 2007, will be reviewed for inclusion in the next periodic update.

EXCISE TAX

Notice 2007–41, page 1287.
The Department of Treasury and the Service invite public comments on recommendations for items that should be included on the 2007–2008 Guidance Priority List. Taxpayers may submit recommendations for guidance at any time during the year. Recommendations submitted by May 31, 2007, will be reviewed for possible inclusion on the original 2007–2008 Guidance Priority List. Recommendations received after May 31, 2007, will be reviewed for inclusion in the next periodic update.

ADMINISTRATIVE

Notice 2007–41, page 1287.
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Announcement 2007–49, page 1300.
This document contains corrections to final regulations (T.D. 9315, 2007–15 I.R.B. 891) that address various dual consolidated loss issues, including exceptions to the general prohibition against using a dual consolidated loss to reduce the taxable income of any other member of the affiliated group.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

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

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

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

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

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

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

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

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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

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

Section 118.—Contributions to the Capital of a Corporation

26 CFR 1.118–1: Contributions to the capital of a corporation.

Contributions to the capital of a corporation; nonshareholder contributions. This ruling provides that payments received by a corporation under the federal universal service support mechanisms do not represent a nonshareholder contribution to capital under section 118(a) of the Code. The federal universal service support mechanisms are funded by contributions from telecommunications carriers. Telecommunications carriers receive support payments to provide discounted telecommunications services or telecommunication services in high cost areas.

Rev. Rul. 2007–31

ISSUE

Is universal service support received by a corporation under the universal service support mechanisms a nonshareholder contribution to capital under section 118(a) of the Internal Revenue Code?

FACTS

The federal universal service support mechanisms are required by 47 U.S.C. § 254. The Federal Communication Commission (Commission) is required to establish periodically the services to be supported by federal universal service support mechanisms. 47 U.S.C. § 254(c)(1). The Commission has established that the following services be supported by federal universal service support mechanisms: (1) voice grade access to the public switched network; (2) local usage; (3) dual tone multi-frequency signaling or its functional equivalent; (4) single-party service or its functional equivalent; (5) access to emergency services; (6) access to operator services; (7) access to interexchange service; (8) access to directory assistance; and (9) toll limitations for qualifying low-income consumers. 47 C.F.R. § 54.101(a). An eligible telecommunications carrier must offer each of the services in order to receive federal universal service support. 47 C.F.R. § 54.101(b).

The Universal Service Administrative Company (Administrator) administers the federal universal service support mechanisms. 47 C.F.R. § 54.701. The Administrator is responsible for administering the following federal universal support mechanisms: (1) the high cost support mechanisms described in 47 C.F.R. part 54, subpart D; (2) the low income support mechanisms described in 47 C.F.R. part 54, subpart E; (3) the schools and libraries support mechanism described in 47 C.F.R. part 54, subpart F; (4) the rural health care support mechanism described in 47 C.F.R. part 54, subpart G; (5) the interstate access universal support mechanism described in 47 C.F.R. part 54, subpart J; and (6) the interstate common line support mechanism described in 47 C.F.R. part 54, subpart K. 47 C.F.R. § 54.702(a). The Administrator is responsible for billing contributors, collecting contributions to the universal service support mechanisms, and disbursing universal service support funds. 47 C.F.R. § 54.702(b).

The federal universal service support mechanisms are funded by contributions from telecommunications carriers. Every telecommunications carrier that provides interstate telecommunications services must contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service. 47 U.S.C. § 254(d). Entities that provide interstate telecommunications services to the public, or to such classes of users as to be effectively available to the public, for a fee will be considered telecommunications carriers providing interstate telecommunications services and must contribute to the universal service support mechanisms. 47 C.F.R. § 54.706(a). Federal universal service contribution costs may be recovered through interstate telecommunications-related charges to end users. 47 C.F.R. § 54.712(a).

In order to receive support, an eligible telecommunications carrier first must provide the supported services. The universal service support provided pursuant to 47 C.F.R. part 54, subparts D, J, and K (identified above) ensures that consumers in all regions of the nation have access to and pay rates for telecommunication services that are reasonably comparable to those in urban areas. The universal service support provided by 47 C.F.R. part 54, subparts E, F, and G (identified above) allows carriers to provide discounted, or reduced, rates to low income consumers, schools and libraries, and rural health care providers. The amount of federal universal service support received depends on either the discount offered to the targeted customers or the cost of providing service (the carrier's revenue requirement) in high cost areas. For financial accounting purposes, the Commission requires all carriers to record their federal universal service support receipts as revenue.

All carriers that receive universal service support must use that support only for the provision, maintenance, and upgrading of facilities and services for which the universal service support is intended. 47 U.S.C. § 254(e) and 47 C.F.R. § 54.7. This includes, for example, the ability to use the funds to reduce intrastate rates, to cover operating expenses (billing and marketing expenses) associated with the supported services, and to upgrade the facilities for the supported services. Annual certifications are required to be filed with the Administrator and the Commission with respect to universal service support from certain universal service support mechanisms stating that all universal service support received from such mechanisms will be used only for the provision, maintenance, and upgrading of facilities and services for which the support is intended.

LAW AND ANALYSIS

Section 118(a) of the Code provides that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. The committee reports accompanying the enactment of what is now section 118(a) indicate that the provision was intended to codify the existing law that had developed through administrative and court decisions on the subject.

H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18 (1954).

Section 1.118–1 of the Income Tax Regulations includes within the meaning of a contribution to capital, a contribution by a nonshareholder and cites as examples of nonshareholder contributions to capital: the value of land and other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion from gross income does not apply to any money or property transferred to the corporation in consideration for goods or services rendered.

In *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943), 1943 C.B. 1019, the Supreme Court held that payments by prospective customers to an electric power company that were used by the company to construct the facilities necessary to deliver electricity to the customers were not nonshareholder contributions to capital. The Court found that the motivation for the prospective customers' contributions was to obtain electric services from the power company and, therefore, the contributions were payment for services. 319 U.S. at 102, 1943 C.B. at 1021.

In contrast, *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950), 1950–1 C.B. 38, held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributors is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital. 339 U.S. at 591, 1950–1 C.B. at 41.

The Court again considered this issue in *United States v. Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1973), 1973–2 C.B. 428. In that case, the Court set forth the following five characteristics of a nonshareholder contribution to capital: (1) the contribution must become a permanent part of transferee's working capital structure; (2) the contribution may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee; (3) the contribution must be bargained for; (4) the asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value; and (5) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect. 412 U.S. at 413, 1973–2 C.B. at 432.

In reaching its conclusion that the improvements at issue did not qualify as contributions to capital, the Court reasoned:

> Although the assets were not payments for specific, quantifiable services performed by CB&Q for the Government as a customer, other characteristics of the transaction lead us to the conclusion that, despite this, the assets did not qualify as contributions to capital. The facilities were not in any real sense bargained for by CB&Q. Indeed, except for the orders by state commissions and the government subsidies, the facilities would not have been constructed at all.

412 U.S. at 413–14, 1973–2 C.B. at 432.

In *Texas & Pacific Railway Co. v. United States*, 286 U.S. 285 (1932), XI–1 C.B. 263, the Court held that payments received by a railroad company from the federal government did not constitute a contribution to capital and thus were includible in income. The Court noted the Transportation Act of 1920 provided for payments representing a guarantee of minimum operating income to compensate the railroad during the transition from federal control to private ownership. The Court reasoned that the payments did not represent capital contributions:

> Here they were to be measured by a deficiency in operating income, and might be used for the payment of dividends, of operating expenses, of capital charges, or for any other purpose …. The Government's payments were not in their nature bounties, but an addition to a depleted operating revenue consequent upon a federal activity.

286 U.S. at 290, XI–1 C.B. at 265.

In *Deason v. Commissioner*, 590 F.2d 1377 (5th Cir. 1979), the Fifth Circuit held that payments received from the Department of Labor for job training for unemployed individuals were not a contribution to capital under section 118. The court affirmed the opinion of the Tax Court, which concluded that irrespective of the public benefit of reduced unemployment that occurred as a result of the payments, the payments constituted direct compensation for training services and thus could not be considered a contribution to capital.

As provided in section 1.118–1 and stated by the Supreme Court in *Detroit Edison* and *Chicago, Burlington & Quincy R.R.*, compensation in exchange for a specific quantifiable service constitutes taxable income, not a capital contribution. Indeed, the Court in *Brown Shoe* premised its decision that inducement payments by community groups to a private corporation for relocating and building a factory constituted a capital contribution, based on the specific absence of customers and payment for services. Conversely, these are precisely the factors that are present in the universal service support. There is a clear nexus between the universal service support and the provision of universal telecommunications services by the carriers. The motivation underlying the universal service support is to compensate the carriers for the shortfall in operating income for providing services at a discount to certain customers and/or providing services to customers in high cost areas at below cost rates. The universal service support is predicated on the carriers providing the mandated universal service and is an integral part of the government's mandate to insure that universal service is provided.

In addition, the universal service support does not satisfy the five characteristics of a nonshareholder contribution to capital set forth in *Chicago, Burlington & Quincy R.R.*, because the universal service support: (1) does not necessarily become a permanent part of the carrier's working capital structure because the support is not limited to the acquisition of capital assets and can be used to pay current expenses; (2) is made for specific, quantifiable telecommunication services to telecommunication customers of the carrier; (3) is not bargained for because the universal service support mechanisms are a unilateral government program and the method of participation by carriers is mandated (despite any certification requirements); (4) does not benefit the carrier commensurate with the value of the support because the support payments merely maintain the carrier's viability; and (5) does not neces-

sarily generate additional income for the carrier because the support is not limited to the acquisition of capital assets that will generate additional income for the carrier, but can be used to pay current expenses or to replace capital assets.

The holdings in *Texas Pacific* and *Deason* also are illustrative in this context. In *Texas Pacific*, the federal government provided payments to fulfill a statutory public purpose and yet because of the inherent nature of the transaction as reimbursement for deficiencies in operating income, the payments did not warrant capital contribution treatment. In *Deason*, the federal government made payments that served the public goal of reducing unemployment. Despite the existence of a public benefit derived from the payment, the court concluded that the payments were compensation for services and therefore ineligible as a capital contribution. Similarly, although a public purpose is served by payment of the universal service support, and the payor is not the consumer of the universal telecommunications services, the universal service support is nonetheless compensation to the carriers for the provision of universal telecommunications services.

HOLDING

Universal service support received by a corporation under the universal service support mechanisms is not a nonshareholder contribution to capital under section 118(a) of the Code.

DRAFTING INFORMATION

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

Section 166.—Bad Debts

A revenue ruling providing guidance as to the period in which a bank that has elected the conformity method of accounting under regulations section 1.166–2(d)(3) can treat uncollected interest as worthless. See Rev. Rul. 2007-32, page 1278.

Section 199.—Income Attributable to Domestic Production Activities

26 CFR 199–9: Application of section 199 to pass-thru entities for taxable years beginning on or before May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005. (Also § 1.199–3T.)

Income attributable to domestic production activities; qualifying in-kind partnerships. This ruling provides that a partnership engaged in the extraction and processing of minerals within the United States is a qualifying in-kind partnership for purposes of section 199 of the Code. Each partner of a qualifying in-kind partnership is treated as having manufactured, produced, grown, or extracted (MPGE) property MPGE by the partnership that is distributed to that partner.

Rev. Rul. 2007–30

This revenue ruling designates the extraction and processing of minerals (as defined in § 1.611–1(d)(5) of the Income Tax Regulations) as an activity within § 1.199–9(i)(2)(iii) and § 1.199–3T(i)(7)(ii)(C) of the temporary Income Tax Regulations. A partnership engaged solely in an activity or industry designated by the Secretary will be a qualifying in-kind partnership under §§ 1.199–9(i)(2) and 1.199–3T(i)(7)(ii).

Pursuant to §§ 1.199–9(i)(1) and 1.199–3T(i)(7)(i), each partner of a qualifying in-kind partnership is treated as having manufactured, produced, grown, or extracted (MPGE) property MPGE by the partnership that is distributed to that partner.

Sections 1.199–9(i)(2) and 1.199–3T(i)(7)(ii) provide that a qualifying in-kind partnership includes a partnership engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States; or the production or generation of electricity in the United States. Under §§ 1.199–9(i)(2)(iii) and 1.199–3T(i)(7)(ii)(C), a qualifying in-kind partnership may include a partnership engaged solely in an activity or industry designated by the Secretary by publication in the Internal Revenue Bulletin.

By this revenue ruling, the Internal Revenue Service designates the extraction and processing of minerals (as defined in § 1.611–1(d)(5)) as an activity within §§ 1.199–9(i)(2)(iii) and 1.199–3T(i)(7)(ii)(C). Accordingly, a partnership engaged solely in the extraction and processing of minerals within the United States will be a qualifying in-kind partnership under §§ 1.199–9(i)(2) and 1.199–3T(i)(7)(ii).

EFFECTIVE DATE

This revenue ruling is effective for taxable years beginning after December 31, 2004, the effective date of § 199. However, for taxable years beginning before June 1, 2006, a taxpayer may apply this revenue ruling only if the taxpayer applies §§ 1.199–1 through 1.199–8 to that taxable year.

DRAFTING INFORMATION

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

Section 446.—General Rule for Methods of Accounting

A revenue ruling requiring an accrual method bank with a reasonable expectation of receiving future payments on a loan to include accrued interest (determined under regulations section 1.446–2) in gross income for the taxable year in which the right to receive the interest becomes fixed, notwithstanding bank regulatory rules that prevent accrual of the interest for regulatory purposes. See Rev. Rul. 2007-32, page 1278.

A revenue procedure providing the procedure under which a bank may change its method of accounting for uncollected interest to an elective safe harbor method based on the bank's collection experience. See Rev. Proc. 2007-33, page 1289.

Section 451.—General Rule for Taxable Year of Inclusion

A revenue procedure providing an elective safe harbor method of accounting for a bank's uncollected interest based on the bank's collection experience. See Rev. Proc. 2007-33, page 1289.

26 CFR 1.451–1: General rule for taxable year of inclusion.
(Also: Part I, §§ 166, 446; 1.166–2, 1.446–1, 1.446–2.)

Accrual of interest. This ruling requires an accrual method bank with a reasonable expectancy of receiving future payments on a loan to include accrued interest (determined under regulations section 1.446–2(a)(2)) in gross income for the taxable year in which the right to receive the interest becomes fixed, notwithstanding bank regulatory rules that prevent accrual of the interest for regulatory purposes. The ruling also provides guidance as to the period in which a bank that has elected the conformity method of accounting under regulations section 1.166–2(d)(3) can treat uncollected interest as worthless. Rev. Rul. 81–18 distinguished.

Rev. Rul. 2007–32

ISSUES

1. If federal banking rules require a bank to suspend the recognition of certain uncollected "accrued interest" as defined in § 1.446–2 of the Income Tax Regulations as income for regulatory financial statement purposes should the bank also cease recognizing uncollected accrued interest into income for federal income tax purposes?

2. If a bank uses a conformity method of accounting as provided for in § 1.166–2(d) but does not recognize uncollected accrued interest as income for regulatory financial statement purposes, when should the bank recognize a worthless debt with respect to uncollected accrued interest for federal income tax purposes?

3. If a bank receives payments on a loan where the bank for federal income tax purposes either (i) previously recognized the uncollected accrued interest as income and subsequently deducted the accrued interest receivable as a worthless debt under section 166 or (ii) did not recognized the uncollected accrued interest on the loan as income, how should the payments be characterized for federal income tax purposes?

FACTS

X corporation is a bank as defined in § 1.166–2(d)(4)(i). X determines its taxable income using an accrual method of accounting and files its federal income tax returns on a calendar year basis. Loans made by X are subject to § 1.446–2, which determines the amount of "accrued interest" related to each loan for federal income tax purposes.

X is subject to regulatory supervision by federal banking authorities ("supervisory authorities") and is required to prepare regulatory financial statements that comply with federal banking rules. For regulatory financial statement purposes, unless a loan is both well secured and in the process of collection, federal banking rules generally require that X suspend the recognition into income of uncollected accrued interest on a loan and reverse any previously recognized uncollected interest income if:

(i) the loan is maintained on a cash basis because of deterioration in the borrower's financial condition;

(ii) payment in full of principal or interest is not expected; or

(iii) payment of principal or interest has been in default for a period of 90 days or more.

Under federal banking rules, a loan may be considered a bankable asset (*i.e.,* not written off for regulatory financial statement purposes) even if accrued interest on the loan is no longer being recognized as income (or was previously recognized and subsequently charged off) for regulatory financial statement purposes. In this revenue ruling, the loan is referred to as a "non-accrual loan receivable."

In general, federal banking rules require a bank such as X to apply any payment received on a non-accrual loan receivable to reduce its recorded investment in the loan (*i.e.,* treat all monies that come in on the loan as a collection of loan principal) to the extent necessary to eliminate doubt as to collectibility. Therefore, for regulatory financial statement purposes, X characterizes any payment received on a non-accrual loan receivable as a payment of principal rather than a payment of the outstanding accrued interest on the loan until the remaining principal on the non-accrual loan receivable is considered to be fully collectible.

On January 16, 2007, X classifies Loan A as a non-accrual loan receivable for regulatory financial statement purposes because an amount of principal or interest has become 90 days past due. Nonetheless, X reasonably expects the borrower to continue making some but not all payments on the loan.

On January 16, 2007, the uncollected accrued interest on Loan A is $9,000 ($8,000 attributable to the calendar year ending December 31, 2006, and $1,000 attributable to the period January 1, 2007 through January 16, 2007). Prior to January 17, 2007, X recognized the $9,000 as income for regulatory financial statement purposes. During the period January 17, 2007 through December 31, 2007, an additional $23,000 of accrued interest becomes due on Loan A.

Pursuant to federal banking rules, on January 16, 2007, X reverses the $9,000 of uncollected accrued interest that had previously been recognized by making adjustments to appropriate income statement and balance sheet accounts for regulatory financial statement purposes. In addition, federal banking rules do not permit X to recognize as income any of the $23,000 accrued interest attributable to the period January 17, 2007 through December 31, 2007.

On January 1, 2008, X receives a $31,000 payment on Loan A. For regulatory financial statement purposes, X characterizes the $31,000 payment as a recovery of principal rather than a recovery of accrued interest. Therefore, X does not recognize any of the $31,000 payment as interest income for regulatory financial statement purposes.

X's supervisory authorities, in connection with the most recent examination of X's regulatory financial statements and lending practices, have determined that X maintains and applies standards that are consistent with federal banking rules.

LAW AND ANALYSIS

Issue 1.

Section 1.446–2 provides rules for determining the amount of accrued interest (other than interest described in § 1.446–2(a)(2)) that is generated on a loan over time for federal income tax purposes.

Section 1.446–2(a)(1) provides that the period in which a taxpayer recognizes accrued interest (determined under § 1.446–2(b) or § 1.446–2(c)) in gross

income is determined under the taxpayer's regular method of accounting.

Section 451(a) provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period.

In the case of an accrual method taxpayer, § 1.451–1(a) provides that income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. *See also* § 1.446–1(c)(1)(ii).

As an accrual method taxpayer, X generally is required to recognize accrued interest determined under § 1.446–2 into gross income for the taxable year in which all the events have occurred which fix the right to receive such interest and the amount thereof can be determined with reasonable accuracy. *See* § 1.451–1(a). Under the "all events" test, a taxpayer's right to receive income becomes fixed on the earlier of the date that: (1) payment is earned through performance; (2) payment is due; or (3) payment is actually received. Rev. Rul. 84–31, 1984–1 C.B. 127. An amount of accrued interest determined pursuant to § 1.446–2 satisfies the "reasonable accuracy" requirement of § 1.451–1(a).

Although federal banking rules do not permit X to recognize accrued interest related to a non-accrual loan receivable as income for regulatory financial statement purposes, regulatory accounting rules are not controlling for federal income tax purposes. *See Old Colony R. Co. v. Commissioner,* 284 U.S. 552, 562 (1932).

"A fixed right to a determinable amount does not require accrual, however, if the income is uncollectible when the right to receive the income item arises. Accrual of income is not required when a fixed right to receive arises if there is not a reasonable expectancy that the claim will ever be paid." *European Am. Bank & Trust Co. v. United States,* 20 Cl. Ct. 594, 605 (1990) (footnotes omitted), *aff'd per curiam,* 940 F.2d 677 (Fed. Cir. 1991); *see also Jones Lumber Co. v. Commissioner*, 404 F.2d 764, 766 (6th Cir. 1968) (stating that "[t]he right to receive . . . determines the accrual of income unless, at the time the right arises, there exists a reasonable doubt as to its collectibility"); *Koehring Co. v. United States,* 421 F.2d 715, 721 (Ct. Cl. 1970) (stating that "a reasonable doubt as to the collectibility of a debt is a sufficient reason to justify its nonaccrual as income"); Rev. Rul. 80–361, 1980–2 C.B. 164 (citing *Jones Lumber Co., supra.*)

The "no reasonable expectancy of payment" exception to the fundamental rules of income accrual is strictly construed. "For accrual of income to be prevented, uncertainty as to collection must be substantial." *European Am. Bank & Trust Co.,* 20 Cl. Ct. at 605. To treat an item as non-accruable because of doubtful collectibility, the cases generally have required substantial evidence as to the financial instability or insolvency of the debtor. *See Jones Lumber Co.,* 404 F.2d at 766. This substantiation requirement has been applied on a loan by loan basis.

Temporary financial difficulty of a debtor cannot support non-recognition of income absent the existence of real doubt regarding ultimate payment. *Koehring Co.,* 421 F.2d 715, 721–722; *see also Harmont Plaza Inc. v. Commissioner,* 64 T.C. 632, 650 (1975), *aff'd,* 549 F.2d 414 (6th Cir. 1977) (stating that "the fact that a lapse of time is contemplated before actual satisfaction is possible does not constitute the requisite doubtful collectibility"). If there is some doubt regarding receipt of payment but a reasonable person would have an expectancy of payment, then an accrual method taxpayer is required to recognize the income.

When an income item is properly accrued and subsequently becomes uncollectible, a taxpayer's remedy is by way of a bad debt deduction under section 166 rather than through elimination of the accrual. Rev. Rul. 80–361. *See also* § 1.166–1(e) (relating to a bad debt deduction for uncollected income items included as income for the taxable year in which the bad debt deduction is claimed or for a prior taxable year); section 585 (allowing certain banks to deduct additions to a reserve for bad debts in lieu of the bad debt deduction provided by section 166) and § 1.585–2(e)(2) (excluding interest that has not been included in gross income from a loan used to determine additions to the reserve for bad debts). This rule is applicable even when the item is accrued and becomes uncollectible during the same taxable year. *Spring City Foundry Co. v. Commissioner,* 292 U.S. 182 (1934). *See also Atlantic Coast Line Railroad Co. v. Commissioner*, 31 B.T.A. 730, 751 (1934), acq., XIV–2 C.B. (1935).

Rev. Rul. 81–18, 1981–1 C.B. 295, addressed an accrual basis savings and loan association operating on a calendar year for federal income tax purposes. On its 1978 income tax return, the savings and loan recognized into income uncollected accrued interest on a loan. However, no interest payments were ever received on the loan. On January 30, 1979, the savings and loan charged off the previously recognized 1978 accrued interest for regulatory financial accounting purposes and recognized a bad debt deduction for federal income tax purposes. The charge-off was made pursuant to then existing Federal Home Loan Bank Board (FHLBB) regulations. The FHLBB regulations required that interest be treated as uncollectible if any portion of the interest was due but uncollected for a period in excess of 90 days. FHLBB examiners, upon their first audit of the savings and loan after the charge-off, confirmed that the charge-off was properly recognized for regulatory financial statement purposes and made in accordance with established policies of the FHLBB. The ruling considered two issues: (1) whether the savings and loan's claim for the uncollected 1978 interest was worthless for purposes of recognizing a section 166 bad debt deduction; and (2) whether the savings and loan was required under section 451 and § 1.451–1(a) to recognize the uncollected accrued interest on the nonperforming loan for periods after December 31, 1978 under the accrual method of accounting. The ruling concluded that for federal income tax purposes, the savings and loan's claim to the 1978 uncollected accrued interest was a worthless debt for purposes of section 166. The ruling also concluded that the savings and loan was not required to recognize any uncollected accrued interest on the loan after December 31, 1978.

Unlike the situation in Rev. Rul. 81–18, where no payments on the loan were made and there was no reasonable expectation of payment, in this revenue ruling X reasonably expects the borrower to continue making some but not all payments on Loan A. Therefore, the borrower's default on Loan A only demonstrates that timely repayment is not

occurring. The late payment of interest by itself is not sufficient to demonstrate that X has no reasonable expectation of payment of the accrued interest related to Loan A. Under these circumstances, the "no reasonable expectancy of payment" exception to the general accrual rule does not apply. *See Koehring Co.,* 421 F.2d at 721–722*; Harmont Plaza Inc.,* 64 T.C. at 650.

As an accrual method taxpayer, X is required to recognize the $8,000 of uncollected 2006 accrued interest as income in X's 2006 taxable year for federal income tax purposes. X is also required to recognize the $24,000 of uncollected 2007 accrued interest in X's 2007 taxable year. The result is the same regardless of whether the bank uses a conformity method of accounting provided for in § 1.166–2(d).

Issue 2.

Section 166(a)(1) provides that a deduction shall be allowed for any debt that becomes worthless during the taxable year. In addition, section 166(a)(2) provides a deduction for "partially worthless debts" not in excess of the part charged off in the taxpayer's books and records within the taxable year to the extent the Commissioner is satisfied that the debt is recoverable only in part. A deduction for a worthless debt arising from an item of taxable income shall be allowed only if the item is recognized as taxable income during the taxable year in which the deduction is claimed or a prior taxable year. *See* § 1.166–1(e).

In general, there is no bright line test for determining the period in which a debt becomes worthless. However, § 1.166–2(d) permits a bank subject to supervision by federal banking authorities to use a conformity method of accounting to determine when a debt becomes worthless. Under a conformity method, debts that are charged off, in whole or in part, for regulatory purposes are conclusively presumed to become worthless for federal income tax purposes at the time of the regulatory charge off. Under a conformity method of accounting, the bank is allowed to recognize a bad debt deduction for the taxable year in which a debt is conclusively presumed to have become worthless. *See* § 1.166–2(d)(3)(ii)(A)(2).

In connection with the most recent examination of X's regulatory financial statements, X's supervisory authorities have determined that X maintains and applies standards that are consistent with federal banking rules. *See* Rev. Proc. 92–84, 1992–2 C.B. 489 (providing the form for the determination). Therefore, X satisfies the express determination requirement of § 1.166–2(d)(3)(iii)(D).

Various procedures can be used by a bank to classify a debt, or portion thereof, as a loss asset described in § 1.166–2(d)(3)(ii)(C). Rev. Rul. 2001–59, 2001–2 C.B. 585. On January 16, 2007, X reverses the recognition of the $9,000 of pre-January 17, 2007 uncollected accrued interest as interest income on Loan A ($8,000 of 2006 interest and $1,000 of interest for the period January 1, 2007 through January 16, 2007) for regulatory financial statement purposes. X's reversal of the accrual of $9,000 of uncollected pre-January 17, 2007 accrued interest, removes the interest receivable from X's books and records for regulatory financial statement purposes. Under federal banking rules, the $9,000 interest receivable is treated as an uncollectible asset of such little value that its inclusion as a bankable asset is not warranted. The reversal of the accrual of the $9,000 of interest receivable constitutes a charge off of the interest receivable as a loss asset for purposes of § 1.166–2(d)(3)(ii)(C).

For regulatory purposes, X does not recognize as income any of the $23,000 of accrued interest attributable to the period January 17, 2007 through December 31, 2007 because X's right to the $23,000 of accrued interest has such little value that recognition of the accrued interest receivable as a bankable asset is not warranted. Under these circumstances, X's failure to recognize the $23,000 of accrued interest for regulatory financial statement purposes is tantamount to recognizing the accrued interest as income and immediately charging off the uncollected accrued interest receivable as a loss asset.

As a result of X's conformity method of accounting under § 1.166–2(d), X will be entitled to claim a worthless debt deduction under section 166 in X's tax year ending December 31, 2007 for the $32,000 of uncollected accrued interest on Loan A ($8,000 of uncollected accrued interest in 2006 and $24,000 of uncollected accrued interest in 2007).

Issue 3.

In general, § 1.446–2(e) provides that each payment made on a loan (other than payments of additional interest or similar charges with regard to amounts that are not paid when due) is treated as a payment of interest to the extent of any accrued interest that is uncollected on the date the payment becomes due. The interest characterization provided for in § 1.446–2(e) applies to all payments made on a loan regardless of the taxpayer's overall method of accounting. For example, the interest characterization provided for in § 1.446–2(e) would apply to a payment on a loan for which the uncollected accrued interest was not previously recognized as income for federal income tax purposes. Similarly, the interest characterization provided for in § 1.446–2(e) would apply to a payment on a loan for which the uncollected accrued interest was previously recognized as income for federal income tax purposes and subsequently deducted as a worthless debt under the taxpayer's method of accounting.

Under § 1.166–1(f), any amount attributable to a recovery of a bad debt, or of a portion of a bad debt, which was allowed as a deduction from gross income in a prior taxable year, is included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of section 111 and § 1.111–1.

On January 1, 2008, X receives a $31,000 payment on Loan A. For regulatory financial statement purposes, X characterizes the $31,000 as a payment of loan principal. However, under § 1.446–2(e), X is required to characterize any payment received on Loan A (other than payments of additional interest or similar charges with regard to amounts that are not paid when due) as a payment of interest for federal income tax purposes to the extent there is uncollected accrued interest outstanding on Loan A.

Immediately prior to the receipt of the $31,000 payment on January 1, 2008, the uncollected accrued interest on Loan A is $32,000 ($8,000 attributable to 2006 and $24,000 attributable to 2007). Therefore, § 1.446–2(e) requires that X characterize

the $31,000 payment on Loan A as a payment of interest for federal income tax purposes. The characterization of the $31,000 payment as interest under § 1.446–2(e) would be the same regardless of whether: (i) X had not yet recognized the $32,000 of uncollected accrued interest on Loan A as income under its method of accounting for federal income tax purposes, (ii) X had recognized the $32,000 of uncollected accrued interest on Loan A as income for federal tax purposes but subsequently deducted the interest receivable as a bad debt under section 166 under its method of accounting, or (iii) X used a conformity method of accounting under § 1.166–2(d).

HOLDINGS

1. X is required to recognize in gross income the uncollected accrued interest on Loan A for federal income tax purposes notwithstanding that federal banking rules required X to suspend the recognition of accrued interest on Loan A into income for regulatory financial statement purposes. For the taxable year ending December 31, 2006, X must recognize in gross income the $8,000 of uncollected accrued interest on Loan A that was generated during 2006. For the taxable year ending December 31, 2007, X must recognize in gross income the $24,000 of uncollected accrued interest on Loan A that was generated during 2007. X must recognize the uncollected accrued interest as gross income in 2006 and 2007 regardless of whether X has elected a conformity method of accounting under § 1.166–2(d)(3) to determine when a debt becomes worthless.

2. As X uses a conformity method of accounting under § 1.166–2(d), X's $32,000 accrued interest receivable related to Loan A ($8,000 of uncollected accrued interest in 2006 and $24,000 of uncollected accrued interest in 2007) is considered worthless for purposes of section 166 in the year the amount is charged off for regulatory financial statement purposes. Therefore, for federal income tax purposes, X is allowed a worthless debt deduction for the $32,000 of uncollected accrued interest written off for regulatory financial statement purposes in the tax year ending December 31, 2007.

3. X is required to characterize the $31,000 payment received on Loan A in 2008 as a payment of interest for federal income tax purposes. The result would be the same whether (i) X had not yet recognized the $32,000 of uncollected accrued interest on Loan A as gross income under its method of accounting for federal income tax purposes, (ii) X had recognized the $32,000 of uncollected accrued interest on Loan A as gross income for federal tax purposes but subsequently deducted the receivable as a bad debt under section 166, or (iii) X used a conformity method of accounting under § 1.166–2(d). If X had previously deducted the $32,000 of uncollected accrued interest as a bad debt for federal income tax purposes then the subsequent $31,000 payment on the loan will be characterized as a partial recovery of that bad debt.

EFFECT ON OTHER RULINGS

Rev. Rul. 81–18 is distinguished with regard to when interest accrues for federal income tax purposes.

DRAFTING INFORMATION

The principal author of this revenue ruling is Timothy Sebastian of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Sebastian (202) 622–7417.

Section 856.—Definition of Real Estate Investment Trust

A notice provides that if a REIT recognizes currency gain under section 987, the REIT may apply the principles of the proposed regulations under section 987 that were issued on September 7, 2006, to determine whether the currency gain is derived from income described in section 856(c)(2) or (3). See Notice 2007-42, page 1288.

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26 CFR 1.856–2: Limitations.
(Also § 988; 1.988–2.)

Real estate investment trust (REIT) foreign currency. This ruling provides that section 988 gain that is recognized by a REIT will be qualifying income under section 856(c)(2) or (3) of the Code to the extent that the underlying income so qualifies.

Rev. Rul. 2007–33

ISSUE

If a real estate investment trust (REIT) recognizes foreign currency gain in a section 988 transaction, to what extent is that gain qualifying income for purposes of the REIT income tests under § 856(c) of the Internal Revenue Code?

FACTS

R, a corporation with the U.S. dollar as its functional currency, has elected, and qualifies, to be treated as a REIT under subchapter M of Chapter 1 of the Code. *R* invests both in real property from which *R* derives rental income and in debt instruments that are partially or fully secured by mortgages on real property.

Some of the leases of the real estate that *R* owns provide for rents to be paid in euros. For some of these leases, *R* recognizes rental income for federal income tax purposes before receiving the corresponding rent payments. *R*'s rental income from these euro-denominated leases is described in § 856(c)(2)(C) and in § 856(c)(3)(A).

Some of the mortgage loans that *R* acquires are denominated in euros, and both principal and interest under these loans are payable in euros. *R*'s interest income from these euro-denominated loans is described in § 856(c)(2)(B) and in § 856(c)(3)(B).

R's activities of investing in rent-producing real estate and in mortgage loans are not subject to § 987. Therefore, if the euro changes in value against the dollar, payments of rent under the leases of the real estate and periodic payments made under the mortgage loans may generate foreign currency gain or loss under § 988. *See* § 1.988–2(b).

During its taxable year, *R* recognized rental income on the euro-denominated leases, interest income on the euro-denominated mortgage loans, and section 988 gain on payments received under the leases and the mortgage loans.

LAW AND ANALYSIS

To qualify as a REIT for a taxable year, at least 95 percent of an entity's gross income must be "derived from" the types of income listed in § 856(c)(2), and at least 75 percent of its gross income must be

"derived from" the types of income listed in § 856(c)(3). Gains from foreign currency are not specifically enumerated in § 856(c)(2) or (c)(3).

Section 988(c)(1) defines a "section 988 transaction" as any transaction described in § 988(c)(1)(B) if the amount which the taxpayer is entitled to receive (or is required to pay) by reason of such transaction is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies. Under § 988(c)(1)(B)(i), a section 988 transaction includes the acquisition of a debt instrument or becoming the obligor under a debt instrument. Under § 988(c)(1)(B)(ii), a section 988 transaction also includes accruing (or otherwise taking into account) any item of gross income or receipts which is received after the date on which so accrued or taken into account.

Section 988(b)(1) provides that the term "foreign currency gain" means any gain from a section 988 transaction to the extent that such gain does not exceed gain realized by reason of changes in exchange rates on or after the booking date (as defined in § 988(c)(2)) and before the payment date (as defined in § 988(c)(3)).

Rev. Rul. 74–191, 1974–1 C.B. 170, holds that otherwise-qualifying assets do not fail to satisfy § 856(c)(4) merely because the assets are foreign:

> Neither section 856 of the Code nor the regulations thereunder restrict the term "real estate assets" to those located within the United States. Accordingly, it is held that, for purposes of section 856(c), the term "real property" includes land or improvements thereon located outside the United States and the term "mortgages on real property" includes a security interest which, under the laws of the jurisdiction in which the property is located, is the legal equivalent of a mortgage or deed of trust in the United States.

1974–1 C.B. at 170. It follows from this holding both that rents on foreign real property qualify under § 856(c)(2)–(3) to the same extent that they would qualify if the property were located in the United States and that interest on foreign mortgage loans qualifies under § 856(c)(2)–(3) to the same extent that it would qualify if the loans were governed by United States law and the property were located in the United States. Thus, foreign situs of a REIT's assets does not necessarily prevent the REIT from satisfying the income and asset tests of § 856(c), which must be met in order to qualify as a REIT. Rev. Rul. 74–191, however, does not address the treatment of foreign currency gain that may result from investing in real property or other assets that produce income denominated in a currency other than the taxpayer's functional currency.

The legislative history describing the tax treatment of REITs indicates that the central concern behind the gross income restrictions in § 856(c) is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960–2 C.B. 819, 822–23 states, "One of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

Although § 856(c) describes the sources of REIT qualifying income, neither the statute nor its legislative history describes what it means for income to be "derived from" those sources. Because of the close nexus, however, between section 988 gain on payments received by a REIT and the income from which that payment is derived, the section 988 gain qualifies under § 856(c)(2) or (3) to the extent that the underlying income does. Thus, for example, if interest income recognized by *R* qualifies under § 856(c)(2) or (3), then so does the 988 gain from that interest income. Similarly, if an item of income qualifies as rents from real property for purposes of § 856(c)(3)(C), then, for purposes of § 856(c)(3), section 988 gain with respect to that income is derived from a type of income listed in § 856(c)(3)(A)–(H). *Cf.* Rev. Rul. 92–56, 1992–2 C.B. 153 (concluding that a regulated investment company's (RIC's) receipt of a reimbursement of an investment advisory fee was "derived from" the RIC's business of investing in stock, securities, or foreign currencies and was therefore qualifying income under the "other income" provision of § 851(b)(2)).

HOLDING

If section 988 gain is recognized with respect to income recognized by a REIT, the gain qualifies under § 856(c)(2) or (3) to the extent that the underlying income so qualifies.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jonathan D. Silver of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Jonathan D. Silver at (202) 622–3930 (not a toll-free call).

Section 987.—Branch Transactions

A notice provides that if a REIT recognizes currency gain under section 987, the REIT may apply the principles of the proposed regulations under section 987 that were issued on September 7, 2006, to determine whether the currency gain is derived from income described in section 856(c)(2) or (3). See Notice 2007-42, page 1288.

Section 988.—Treatment of Certain Foreign Currency Transactions

A revenue ruling holds that if section 988 gain is recognized with respect to income recognized by a REIT, the gain qualifies under section 856(c)(2) or (3) to the extent that the underlying income so qualifies. See Rev. Rul. 2007-33, page 1281.

Section 1035.—Certain Exchanges of Insurance Policies

26 CFR 1.1035–1: Certain exchanges of insurance policies.
(Also § 72.)

Section 1035; certain exchanges of insurance policies. A taxpayer's receipt of a check issued by an insurance company under a non-qualified annuity contract is treated as a taxable distribution, even if the check is endorsed to a second insurance company for the purchase of a second annuity. The transaction is not characterized as a tax-free exchange under section 1035(a)(3) of the Code unless there is a direct exchange or assignment of the original contract.

Rev. Rul. 2007–24

ISSUE

If a Taxpayer receives a check from a life insurance company under a non-qualified annuity contract, does the endorsement of the check to a second company as consideration for a second annuity contract qualify as a tax-free exchange under § 1035(a)(3) of the Internal Revenue Code?

FACTS

A, an individual, owned a non-qualified annuity contract issued by *IC1*, a life insurance company. In 2007, *A* requested that *IC1* issue directly to *IC2*, another life insurance company, a check as consideration for a new annuity contract to be issued by *IC2*. *A* intended the transaction to be treated as a tax-free exchange under § 1035. *IC1* refused to do so and, instead, issued a check to *A*. *A* did not deposit the check, but instead endorsed it to *IC2* as consideration for a new annuity contract.

LAW AND ANALYSIS

Section 72(a) provides that, except as otherwise provided in Chapter 1 of the Internal Revenue Code, gross income includes any amount received as an annuity under an annuity contract. Under § 72(e), amounts received under an annuity contract, but not as an annuity, generally are included in gross income to the extent allocable to income on the contract. That is, they are taxed on an income-first basis. Section 72(e)(5)(E) provides that this rule applies to any amounts received on the complete surrender, redemption, or maturity of an annuity contract.

Section 1035(a)(3) provides that no gain or loss is recognized on the exchange of an annuity contract for another annuity contract. The legislative history of § 1035 explains that § 1035 provides non-recognition treatment for taxpayers who have "merely exchanged an [annuity contract] for another better suited to their needs and who have not actually realized gain." H. Rep. 1337, 83d Cong., 2d Sess. 81 (1954). Under § 1.1035–1, the contracts exchanged must relate to the same insured, and the obligee or obligees under the contract received in the exchange must be the same as those under the original contract.

In Rev. Rul. 72–358, 1972–2 C.B. 473, a taxpayer who owned a life insurance contract issued by one insurance company assigned the contract, prior to its maturity, to a second insurance company in exchange for a variable annuity contract issued by the second company. The ruling concludes that, pursuant to § 1035, no gain or loss is recognized on the exchange. Similarly, Rev. Rul. 2002–75, 2002–2 C.B. 812, concludes that an individual's assignment of an annuity contract issued by one insurance company to a second insurance company, which then deposits the cash surrender value of the assigned contract into a pre-existing annuity contract owned by the same taxpayer, qualifies as a tax-free exchange under § 1035.

In the present case, there was no actual exchange of annuity contracts; nor did *A* assign the *IC1* contract to *IC2*; nor was there a direct transfer from *IC1* to *IC2* of the cash value of the old contract in exchange for the new contract. Instead, *IC1* disbursed a check to *A*, which *A*, in turn, endorsed to *IC2* as consideration for a new contract. Neither § 1035 nor the regulations make any special provision for the purchase of an annuity contract with amounts distributed to the policyholder under another contract. Because the annuity contract was a non-qualified contract, no rollover provision, such as § 403(a)(4), applied to the amount received from *IC1*. Accordingly, the amount that *A* received from *IC1* under the first annuity contract is taxable in 2007 to the extent set forth in § 72(e).

HOLDING

If a Taxpayer receives a check from a life insurance company under a non-qualified annuity contract, the endorsement of the check to a second company as consideration for a second annuity contract does not qualify as a tax-free exchange under § 1035(a)(3). Instead, the amount received is taxable to the extent set forth in § 72(e).

DRAFTING INFORMATION

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

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rates Update

Notice 2007–33

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

CORPORATE BOND WEIGHTED AVERAGE INTEREST RATE

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

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

The composite corporate bond rate for April 2007 is 5.98 percent. Pursuant to Notice 2004–34, the Service has determined this rate as the average of the monthly yields for the included corporate bond indices for that month.

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

Month	For Plan Years Beginning in: Year	Corporate Bond Weighted Average	90% to 100% Permissible Range
May	2007	5.80	5.22 to 5.80

30-YEAR TREASURY SECURITIES INTEREST RATE

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

The rate of interest on 30-year Treasury securities for April 2007 is 4.87 percent. The Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2037.

Drafting Information

The principal authors of this notice are Paul Stern and Tony Montanaro of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 877–829–5500 (a toll-free number), between the hours of 8:30 a.m. and 4:30 p.m. Eastern time, Monday through Friday. Mr. Stern may be reached at 202–283–9703. Mr. Montanaro may be reached at 202–283–9714. The telephone numbers in the preceding sentences are not toll-free.

Credit for Renewable Electricity Production, Refined Coal Production, and Indian Coal Production, and Publication of Inflation Adjustment Factors and Reference Prices for Calendar Year 2007

Notice 2007–40

This notice publishes the inflation adjustment factors and reference prices for calendar year 2007 for the renewable electricity production credit, the refined coal production credit, and the Indian coal production credit under § 45 of the Internal Revenue Code. The 2007 inflation adjustment factors and reference prices are used in determining the availability of the credits. The 2007 inflation adjustment factors and reference prices apply to calendar year 2007 sales of kilowatt-hours of electricity produced in the United States or a possession thereof from qualified energy resources and to calendar year 2007 sales of refined coal and Indian coal produced in the United States or a possession thereof.

BACKGROUND

Section 45(a) provides that the renewable electricity production credit for any tax year is an amount equal to the product of 1.5 cents multiplied by the kilowatt hours of specified electricity produced by the taxpayer and sold to an unrelated person during the tax year. This electricity must be produced from qualified energy resources and at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service.

Section 45(b)(1) provides that the amount of the credit determined under § 45(a) is reduced by an amount which bears the same ratio to the amount of the credit as (A) the amount by which the reference price for the calendar year in which the sale occurs exceeds 8 cents, bears to (B) 3 cents. Under § 45(b)(2), the 1.5 cent amount in § 45(a), the 8 cent amount in § 45(b)(1), the $4.375 amount in § 45(e)(8)(A), and in § 45(e)(8)(B)(i) the reference price of fuel used as feedstock (within the meaning of § 45(c)(7)(A)) in 2002 are each adjusted by multiplying the amount by the inflation adjustment factor for the calendar year in which the sale occurs. If any amount as increased under the preceding sentence is not a multiple of 0.1 cent, the amount is rounded to the nearest multiple of 0.1 cent.

Section 45(c)(1) defines qualified energy resources as wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production.

Section 45(d)(1) defines a qualified facility using wind to produce electricity as any facility owned by the taxpayer that is originally placed in service after December 31, 1993, and before January 1, 2009. See § 45(e)(7) for rules relating to the inapplicability of the credit to electricity sold to utilities under certain contracts.

Section 45(d)(2)(A) defines a qualified facility using closed-loop biomass to produce electricity as any facility (i) owned by the taxpayer that is originally placed in service after December 31, 1992, and before January 1, 2009, or (ii) owned by the taxpayer which before January 1, 2009, is originally placed in service and modified to use closed-loop biomass to co-fire with coal, with other biomass, or with both, but only if the modification is approved under the Biomass Power for Rural Development Programs or is part of a pilot project of the Commodity Credit Corporation as described in 65 Fed. Reg. 63052. Section 45(d)(2)(B) provides that in the case of a qualified facility described in § 45(d)(2)(A)(ii), (i) the 10-year period referred to in § 45(a) is treated as beginning no earlier than the date of enactment of § 45(d)(2)(B)(i); (ii) the amount of the credit determined under § 45(a) with respect to the facility is an amount equal to the amount determined without regard to § 45(d)(2)(B)(ii) multiplied by the ratio of the thermal content of the closed-loop biomass used in the facility to the thermal content of all fuels used in the facility; and (iii) if the owner of the facility is not the producer of the electricity, the person eligible for the credit allowable under § 45(a) is the lessee or the operator of the facility.

Section 45(d)(3)(A) defines a qualified facility using open-loop biomass to produce electricity as any facility owned by the taxpayer which (i) in the case of a facility using agricultural livestock waste nutrients, (I) is originally placed in service after the date of enactment of § 45(d)(3)(A)(i)(I) and before January 1, 2009, and (II) the nameplate capacity rating of which is not less than 150 kilowatts; and (ii) in the case of any other facility, is originally placed in service before January 1, 2009. In the case of any facility described in § 45(d)(3)(A), if the owner of the facility is not the producer of the electricity, § 45(d)(3)(B) provides that the person eligible for the credit allowable under § 45(a) is the lessee or the operator of the facility.

Section 45(d)(4) defines a qualified facility using geothermal or solar energy to produce electricity as any facility owned by the taxpayer which is originally placed in service after the date of enactment of § 45(d)(4) and before January 1, 2009 (January 1, 2006, in the case of a facility using solar energy). A qualified facility using geothermal or solar energy does not include any property described in § 48(a)(3) the basis of which is taken into account by the taxpayer for purposes of determining the energy credit under § 48.

Section 45(d)(5) defines a qualified facility using small irrigation power to produce electricity as any facility owned by the taxpayer which is originally placed in service after the date of enactment of § 45(d)(5) and before January 1, 2009.

Section 45(d)(6) defines a qualified facility using gas derived from the biodegradation of municipal solid waste to produce electricity as any facility owned by the taxpayer which is originally placed in service after the date of enactment of § 45(d)(6) and before January 1, 2009.

Section 45(d)(7) defines a qualified facility that burns municipal solid waste to produce electricity as any facility owned by the taxpayer which is originally placed in service after the date of enactment of § 45(d)(7) and before January 1, 2009. A qualified facility burning municipal solid waste includes a new unit placed in service in connection with a facility placed in service on or before the date of enactment of § 45(d)(7), but only to the extent of the increased amount of electricity produced at the facility by reason of such new unit.

Section 45(d)(8) provides in the case of a facility that produces refined coal, the term "refined coal production facility" means a facility which is placed in service after the date of enactment of § 45(d)(8) and before January 1, 2009.

Section 45(d)(9) defines a qualified facility producing qualified hydroelectric production described in § 45(c)(8) as (A) any facility producing incremental hydropower production, but only to the extent of its incremental hydropower production attributable to efficiency improvements or additions to capacity described in § 45(c)(8)(B) placed in service after the date of enactment of § 45(d)(9) and before January 1, 2009, and (B) any other facility placed in service after the date of enactment of § 45(d)(9) and before January 1, 2009. Section 45(d)(9)(C) provides that in the case of a qualified facility described in § 45(d)(9)(A), the 10-year period referred to in § 45(a) is treated as beginning on the date the efficiency improvements or additions to capacity are placed in service.

Section 45(d)(10) provides in the case of a facility that produces Indian coal, the term "Indian coal production facility" means a facility which is placed in service before January 1, 2009.

Section 45(e)(8)(A) provides that the refined coal production credit is an amount equal to $4.375 per ton of qualified refined coal (i) produced by the taxpayer at a refined coal production facility during the 10-year period beginning on the

date the facility was originally placed in service, and (ii) sold by the taxpayer (I) to an unrelated person and (II) during the 10-year period and the tax year. Section 45(e)(8)(B) provides that the amount of credit determined under § 45(e)(8)(A) is reduced by an amount which bears the same ratio to the amount of the increase as (i) the amount by which the reference price of fuel used as feedstock (within the meaning of § 45(c)(7)(A)) for the calendar year in which the sale occurs exceeds an amount equal to 1.7 multiplied by the reference price for such fuel in 2002, bears to (ii) $8.75.

Section 45(e)(10)(A) provides in the case of a producer of Indian coal, the credit determined under section 45 for any taxable year shall be increased by an amount equal to the applicable dollar amount per ton of Indian coal (i) produced by the taxpayer at an Indian coal production facility during the 7-year period beginning on January 1, 2006, and (ii) sold by the taxpayer (I) to an unrelated person, and (II) during such 7-year period and such taxable year.

Section 45(e)(10)(B)(i) defines "applicable dollar amount" for any taxable year as (I) $1.50 in the case of calendar years 2006 through 2009, and (II) $2.00 in the case of calendar years beginning after 2009.

Section 45(e)(2)(A) requires the Secretary to determine and publish in the Federal Register each calendar year the inflation adjustment factor and the reference price for the calendar year. The inflation adjustment factors and the reference prices for the 2007 calendar year were published in the Federal Register on March 29, 2007 (72 Fed. Reg. 14862).

Section 45(e)(2)(B) defines the inflation adjustment factor for a calendar year as the fraction the numerator of which is the GDP implicit price deflator for the preceding calendar year and the denominator of which is the GDP implicit price deflator for the calendar year 1992. The term "GDP implicit price deflator" means the most recent revision of the implicit price deflator for the gross domestic product as computed and published by the Department of Commerce before March 15 of the calendar year.

Section 45(e)(2)(C) provides that the reference price is the Secretary's determination of the annual average contract price per kilowatt hour of electricity generated from the same qualified energy resource and sold in the previous year in the United States. Only contracts entered into after December 31, 1989, are taken into account.

Under § 45(e)(8)(C), the determination of the reference price for fuel used as feedstock within the meaning of § 45(c)(7)(A) is made according to rules similar to the rules under § 45(e)(2)(C).

Under section 45(e)(10)(B)(ii), in the case of any calendar year after 2006, each of the dollar amounts under section 45(e)(10)(B)(i) shall be equal to the product of such dollar amount and the inflation adjustment factor determined under section 45(e)(2)(B) for the calendar year, except that section 45(e)(2)(B) shall be applied by substituting 2005 for 1992.

INFLATION ADJUSTMENT FACTORS AND REFERENCE PRICES

The inflation adjustment factor for calendar year 2007 for qualified energy resources and refined coal is 1.3433. The inflation adjustment factor for Indian coal is 1.0293. The reference price for calendar year 2007 for facilities producing electricity from wind (based upon information provided by the Department of Energy) is 3.29 cents per kilowatt hour. The reference prices for fuel used as feedstock within the meaning of § 45(c)(7)(A), relating to refined coal production (based upon information provided by the Department of Energy) are $31.90 per ton for calendar year 2002 and $48.35 per ton for calendar year 2007. The reference prices for facilities producing electricity from closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production have not been determined for calendar year 2007. The IRS is exploring methods of determining those reference prices for calendar year 2008.

PHASE-OUT CALCULATION

Because the 2007 reference price for electricity produced from wind does not exceed 8 cents multiplied by the inflation adjustment factor, the phaseout of the credit provided in § 45(b)(1) does not apply to such electricity sold during calendar year 2007. Because the 2007 reference price of fuel used as feedstock for refined coal does not exceed the $31.90 reference price of such fuel in 2002 multiplied by the inflation adjustment factor and 1.7, the phaseout of credit provided in § 45(e)(8)(B) does not apply to refined coal sold during calendar year 2007. Further, for electricity produced from closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production, the phaseout of credit provided in § 45(b)(1) does not apply to such electricity sold during calendar year 2007.

CREDIT AMOUNT BY QUALIFIED ENERGY RESOURCE AND FACILITY, REFINED COAL, AND INDIAN COAL

As required by § 45(b)(2), the 1.5 cent amount in § 45(a)(1), the 8 cent amount in § 45(b)(1), and the $4.375 amount in § 45(e)(8)(A) are each adjusted by multiplying such amount by the inflation adjustment factor for the calendar year in which the sale occurs. If any amount as increased under the preceding sentence is not a multiple of 0.1 cent, such amount is rounded to the nearest multiple of 0.1 cent. In the case of electricity produced in open-loop biomass facilities, small irrigation power facilities, landfill gas facilities, trash combustion facilities, and qualified hydropower facilities, § 45(b)(4)(A) requires the amount in effect under § 45(a)(1) (before rounding to the nearest 0.1 cent) to be reduced by one-half. Under the calculation required by § 45(b)(2), the credit for renewable electricity production for calendar year 2007 under § 45(a) is 2.0 cents per kilowatt hour on the sale of electricity produced from the qualified energy resources of wind, closed-loop biomass, geothermal energy, and solar energy, and 1.0 cent per kilowatt hour on the sale of electricity produced in open-loop biomass facilities, small irrigation power facilities, landfill gas facilities, trash combustion facilities, and qualified hydropower facilities. Under the calculation required by § 45(b)(2), the credit for refined coal production for calendar year 2007 under section 45(e)(8)(A) is $5.877 per ton on the sale of qualified refined coal. The credit for Indian coal production for calendar year 2007 under § 45(e)(10)(B) is $1.544 per ton on the sale of Indian coal.

DRAFTING AND CONTACT INFORMATION

The principal author of this notice is David A. Selig of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Selig at (202) 622–3040 (not a toll-free call).

Public Comment Invited on Recommendations for 2007–2008 Guidance Priority List

Notice 2007–41

The Department of Treasury and Internal Revenue Service invite public comment on recommendations for items that should be included on the 2007–2008 Guidance Priority List.

Treasury's Office of Tax Policy and the Service use the Guidance Priority List each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The 2007–2008 Guidance Priority List will establish the guidance that the Treasury Department and the Service intend to issue from July 1, 2007, through June 30, 2008. The Treasury Department and the Service recognize the importance of public input to formulate a Guidance Priority List that focuses resources on guidance items that are most important to taxpayers and tax administration. Published guidance plays an important role in increasing voluntary compliance by helping to clarify ambiguous areas of the tax law.

As is the case whenever significant legislation is enacted, the Treasury Department and the Service have continued to dedicate substantial resources during the current plan year to published guidance projects necessary to implement the provisions of the American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat. 1418, which was enacted on October 22, 2004; the Energy Policy Act of 2005, Pub. L. No. 109–58, 119 Stat. 594, which was enacted on August 8, 2005; the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109–135, 119 Stat. 2577, which was enacted on December 21, 2005; and the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109–222, 120 Stat. 345, which was enacted on May 17, 2006. Similarly, the Treasury Department and the Service have devoted substantial resources to published guidance projects necessary to implement the provisions of additional tax legislation that was enacted during the current plan year, such as the Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780, which was enacted on August 17, 2006; and the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, 120 Stat. 2922, which was enacted on December 20, 2006. The Treasury Department and the Service will continue to evaluate the priority of each guidance project in light of the above-mentioned tax legislation and other developments occurring during the 2007–2008 plan year.

In reviewing recommendations and selecting projects for inclusion on the 2007–2008 Guidance Priority List, the Treasury Department and the Service will consider the following:

1. Whether the recommended guidance resolves significant issues relevant to many taxpayers;

2. Whether the recommended guidance promotes sound tax administration;

3. Whether the recommended guidance can be drafted in a manner that will enable taxpayers to easily understand and apply the guidance;

4. Whether the Service can administer the recommended guidance on a uniform basis; and

5. Whether the recommended guidance reduces controversy and lessens the burden on taxpayers or the Service.

Taxpayers may submit recommendations for guidance at any time during the year. Please submit recommendations by May 31, 2007, for possible inclusion on the original 2007–2008 Guidance Priority List. The Service plans to update the 2007–2008 Guidance Priority List periodically to reflect additional guidance that the Treasury Department and the Service intend to publish during the plan year. The periodic updates allow the Treasury Department and the Service to respond to the need for additional guidance that may arise during the plan year. Recommendations for guidance received after May 31, 2007, will be reviewed for inclusion in the next periodic update.

Taxpayers are not required to submit recommendations for guidance in any particular format. Taxpayers should, however, briefly describe the recommended guidance and explain the need for the guidance. In addition, taxpayers may include an analysis of how the issue should be resolved. It would be helpful if taxpayers suggesting more than one guidance project would prioritize the projects by order of importance. If a large number of projects are being suggested, it also would be helpful if the projects were grouped in terms of high, medium or low priority.

Taxpayers should send written comments to:

Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2007–41)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand deliver comments Monday through Friday between the hours of 8 a.m. and 4 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2007–41)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, taxpayers may submit comments electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov*. Taxpayers should include "Notice 2007–41" in the subject line. All comments will be available for public inspection and copying in their entirety.

For further information regarding this notice, contact Henry Schneiderman of the Office of Associate Chief Counsel (Procedure and Administration) at (202) 622–3400 (not a toll-free call).

Treatment of Currency Gain That a Real Estate Investment Trust (REIT) Recognizes From a Qualified Business Unit (QBU) of the REIT

Notice 2007–42

This notice provides guidance with respect to the circumstances under which § 856(c)(2) or § 856(c)(3) characterizes § 987 gain as qualifying income for purposes of REIT qualification.

BACKGROUND

Under paragraph (3) of § 856(c), at least 75 percent of a REIT's annual gross income must be derived from the types of income listed in that paragraph, often characterized as income from real estate sources. Under paragraph (2) of § 856(c), at least 95 percent of a REIT's annual gross income must be derived from the types of income listed in that paragraph, often characterized as income from "passive" sources, including interest and dividends.

The Service is aware that some REITs have invested in real estate assets outside the United States through entities or partnerships that qualify as QBUs, as defined in § 989(a). The Service has explicitly ruled that otherwise-qualifying assets do not fail to satisfy § 856(c)(4) merely because the assets are foreign:

> Neither section 856 of the Code nor the regulations thereunder restrict the term "real estate assets" to those located within the United States. Accordingly, it is held that, for purposes of section 856(c), the term "real property" includes land or improvements thereon located outside the United States and the term "mortgages on real property" includes a security interest which, under the laws of the jurisdiction in which the property is located, is the legal equivalent of a mortgage or deed of trust in the United States.

Rev. Rul. 74–191, 1974–1 C.B. 170, 170. It follows from this holding both that rents on foreign real property qualify under § 856(c)(2)–(3) to the same extent that they would qualify if the property were located in the United States, and that interest on foreign mortgage loans qualifies under § 856(c)(2)–(3) to the same extent that it would qualify if the loans were governed by United States law and the property were located in the United States. Thus, foreign situs of a REIT's assets does not necessarily prevent the REIT from satisfying the income and asset tests of § 856(c), which must be met in order to qualify as a REIT. Rev. Rul. 74–191, however, does not address the treatment of foreign currency gain that may result from investing in real property or other assets through a QBU with a functional currency other than the dollar.

In general, § 985 provides that all determinations for federal income tax purposes are to be made in the taxpayer's functional currency. Section 985(a). Section 1.985–1(b)(1)(iii) of the Income Tax Regulations provides that, except as otherwise provided by ruling or administrative pronouncement, the U.S. dollar is the functional currency of a QBU that has the United States as its residence, as defined in § 988(a)(3)(B). Section 1.989(a)–1(b)(2)(i) provides that a corporation is a QBU. Section 988(a)(3)(B)(i)(II) provides that the United States is the residence of a corporation that is a United States person. Section 7701(a)(30) provides, in part, that the term "United States person" includes a domestic corporation. Section 7701(a)(4) provides that the term "domestic," as applied to a corporation, means created or organized in the United States or under the law of the United States or any State. Thus, absent a ruling to the contrary, a REIT has the dollar as its functional currency because § 856(a)(3) requires it to be taxable as a domestic corporation.

A REIT may have a QBU that is subject to § 987 and that has a functional currency other than the dollar. *See* § 1.985–1(c). In such a case, a REIT may recognize currency gain under § 987 when the QBU remits property to the REIT. Section 987(3).

Proposed regulations (REG–208270–86, 2006–42 I.R.B. 698 [71 FR 52,876]) under § 987 were issued September 7, 2006. Section 1.987–6(b) of the proposed regulations generally provides that the owner of a § 987 QBU must determine the character of § 987 gain or loss in the year of remittance using the asset method provided in § 1.861–9T(g), as modified by the proposed regulations. The modified gross income method described in § 1.861–9T(j) cannot be used. If finalized as currently proposed, however, the regulations will not apply to REITs. *See* Prop. Treas. Reg. § 1.987–1(b)(1)(iii). Some REITs have requested guidance concerning the status under § 856(c)(2)–(3) of any foreign currency gain that is recognized under § 987 when a QBU remits property to a REIT.

INTERIM GUIDANCE

Because the currency gain from remittances is determined under § 987, the Service believes that it is appropriate for issues that arise in connection with that gain to be addressed under methods similar to those provided in § 987 and the regulations thereunder. The Treasury Department and the Service therefore intend to amend the proposed regulations under § 987 to include guidance concerning the characterization for purposes of § 856(c)(2) and (3) of § 987 gain recognized by a REIT on a remittance from a QBU of the REIT.

Until further guidance is published, if a REIT recognizes § 987 gain, the REIT may apply the principles of the proposed regulations under § 987 issued September 7, 2006 to determine whether that § 987 gain is derived from income that is described in § 856(c)(2)(A) – (H) or § 856(c)(3)(A) – (I).

The principal author of this notice is Jonathan D. Silver of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Jonathan D. Silver at (202) 622–3930 (not a toll-free call).

26 CFR 601.601: Rules and regulations.
(Also, Part I, §§ 446, 451; 1.446–2, 1.451–1.)

Rev. Proc. 2007–33

TABLE OF CONTENTS

SECTION 1. PURPOSE

This revenue procedure provides the exclusive procedure by which a taxpayer described in SECTION 3 may obtain the Commissioner's consent to change its method of accounting for uncollected interest (other than interest described in § 1.446–2(a)(2) of the Income Tax Regulations) to the safe harbor method provided in SECTION 4 of this revenue procedure.

SECTION 2. BACKGROUND

.01 For certain types of interest, § 1.446–2 provides rules for determining the amount of interest that accrues during an accrual period and the portion of a payment that consists of accrued interest. For descriptions of the types of interest (*e.g.*, original issue discount) to which the § 1.446–2 accrual rules do not apply, see 1.446–2(a)(2).

.02 Section 1.446–2(b) provides that "qualified stated interest" accrues ratably over an accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods). In general, "qualified stated interest" is stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer) at least annually at a single fixed rate that appropriately takes into account the length of the interval between payments. *See* 1.1273–1(c).

.03 In the case of interest other than "qualified stated interest," § 1.446–2(c) provides that the amount of interest that accrues for any accrual period is determined under rules similar to those in the regulations under sections 1272 and 1275 of the Internal Revenue Code for the accrual of original issue discount (subject to the modifications set forth in § 1.446–2(d)).

.04 Section 1.446–2(e) provides that each payment on a loan (other than payments of additional interest or similar charges with regard to amounts not paid when due) is treated as a payment of interest to the extent of the accrued but unpaid interest (determined under § 1.446–2(b) and § 1.446–2(c)) as of the date the payment becomes due.

.05 Section 1.446–2(a)(1) provides that a taxpayer determines the taxable year in which to include an amount of accrued interest (determined under § 1.446–2(b) or § 1.446–2(c)) in gross income under the taxpayer's regular method of accounting.

.06 Rev. Rul. 2007–32, page 1278 of this Bulletin, requires an accrual method bank with a reasonable expectancy of receiving future payments on a loan to accrue interest in the taxable year in which the right to receive the interest becomes fixed, notwithstanding bank regulatory rules that prevent accrual of the interest for regulatory purposes. The ruling also provides guidance as to the period in which a taxpayer that has elected the conformity method of accounting under 1.166–2(d)(3) can treat uncollected interest as worthless.

.07 APPENDIX 5A of Rev. Proc. 2002–9, 2002–1 C.B. 327, modified and clarified by Announcement 2002–17, 2002–1 C.B. 561, modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, amplified, clarified, and modified by Rev. Proc. 2002–54, 2002–2 C.B. 432, states that "for interest to be determined uncollectible, the taxpayer must substantiate, taking into account all the facts and circumstances, that it has no reasonable expectation of payment of the interest." APPENDIX 5A of Rev. Proc. 2002–9 also states that the "substantiation requirement is applied on a loan by loan basis."

.08 Substantiation of uncollectible interest using a loan-by-loan facts and circumstances methodology can be administratively burdensome and impractical, particularly for smaller unsecured loans. For example, a bank may have a significant number of consumer loans. For these loans, the bank's loan files often may not contain updated information regarding the debtors' financial condition or the value of the collateral, if any, securing the loans.

SECTION 3. SCOPE

This revenue procedure applies to a "bank" as defined in 1.166–2(d)(4)(i) that—

(1) uses an accrual method of accounting to determine its taxable income for federal income tax purposes,

(2) is subject to supervision by Federal authorities, or by state authorities maintaining substantially equivalent standards, and

(3) has uncollected interest other than interest described in 1.446–2(a)(2).

SECTION 4. SAFE HARBOR METHOD OF ACCOUNTING FOR UNCOLLECTED INTEREST

.01 *Safe Harbor Method*. Under the safe harbor method of accounting provided by this SECTION 4, a bank determines for each taxable year the amount of uncollected interest (other than interest described in 1.446–2(a)(2)) for which it is considered to have a reasonable expectancy of payment by multiplying: (1) the total accrued (determined under § 1.446–2) but uncollected interest for the year by, (2) the bank's "recovery percentage" (determined under paragraph .02 of this SECTION 4) for that year. Solely for purposes of this safe harbor, the bank is not considered to have a reasonable expectancy of payment for the excess, if any, of the accrued but uncollected interest over the expected collection amount determined using the bank's recovery percentage. The bank includes in gross income the portion of accrued but uncollected interest for which it has a reasonable expectancy of payment. The bank excludes from income the portion of accrued but uncollected interest for which it has no reasonable expectancy of payment.

.02 *Recovery Percentage*. (1) Subject to the limitations and conditions in subparagraphs (2) – (4) of this SECTION 4.02, a bank determines its recovery percentage for each taxable year by dividing—

(a) total payments that the bank received on loans (including principal and interest) during the 5 taxable years immediately preceding the taxable year (or, with the approval of the Commissioner, a shorter period if the bank has less than 6 years of collection experience, *i.e.*, the taxable year and the 5 immediately preceding taxable years), by

(b) total amounts that were due and payable to the bank on loans during the same 5 (or fewer) taxable years.

(2) The recovery percentage cannot exceed 100 percent.

(3) The recovery percentage must be calculated to at least four decimal places.

(4) The data used in the recovery percentage must take into account acquisitions and dispositions as follows:

(a) If a bank acquires the major portion of a trade or business of another person (predecessor) or the major portion of a separate unit of a trade or business of a predecessor, then in applying this revenue procedure for any taxable year ending on or after the acquisition, the data from preceding taxable years of the predecessor attributable to the portion of the trade or business acquired, if available, must be used in determining the bank's recovery percentage.

(b) If a bank disposes of a major portion of a trade or business or the major portion of a separate unit of a trade or business, and the bank furnished the acquiring person the information necessary for the computations required by this revenue procedure, then in applying this revenue procedure for any taxable year ending on or after the disposition, the data from preceding taxable years attributable to the disposed portion of the trade or business may not be used in determining the bank's recovery percentage.

SECTION 5. EXAMPLE

.01 *Facts*. Bank X is a calendar year taxpayer that determines its taxable income using an accrual method of accounting. For 2007, Bank X's accrued but uncollected interest (determined under § 1.446–2) is $51,600. Bank X uses the safe harbor method of accounting described in SECTION 4 of this revenue procedure to determine the amount of uncollected interest for which the Bank has a reasonable expectancy of payment. During the 5 immediately preceding taxable years, Bank X received $73,048,313 of payments on all of its loans. During the same 5-year period, $74,900,705 was due and payable on the loans.

.02 *Analysis*. (1) To determine the portion of the accrued but uncollected interest for which there is a reasonable expectancy of payment, Bank X first calculates its recovery percentage for 2007. Bank X determines its recovery percentage by dividing the $73,048,313 of payments received during the 2002–2006 period by the $74,900,705 that was due and payable during the same period. Bank X's 2007 recovery percentage is 97.5269% [$73,048,313 ÷ $74,900,705 = 97.5269%]. Bank X determines the portion of the uncollected 2007 interest for which it is considered to have a reasonable expectancy of payment by multiplying the $51,600 of accrued but uncollected interest for that year by the 97.5269 recovery percentage. Bank X has a reasonable expectancy of payment for $50,323.88 of the uncollected 2007 interest [$51,600 × 97.5269% = $50,323.88]. Bank X includes the $50,323.88 of uncollected 2007 interest in gross income for 2007.

(2) Bank X is considered not to have a reasonable expectancy of payment for $1,276.12 of the uncollected 2007 interest ($51,600 - $50,323.88 = $1,276.12). Bank X excludes $1,276.12 of the uncollected 2007 interest from its 2007 gross income.

SECTION 6. ADOPTION OF SAFE HARBOR METHOD OF ACCOUNTING

.01 Any change to the safe harbor method provided in SECTION 4 of this revenue procedure is a change in method of accounting to which the provisions of section 446 and section 481, and the regulations thereunder, apply. Under § 1.446–1(e)(2)(i), a taxpayer generally must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the terms and conditions necessary to obtain consent to change a method of accounting.

.02 If a bank with less than 6 years of collection experience wants to change its method of accounting for uncollected interest to the safe harbor method provided in SECTION 4 of this revenue procedure, the bank is required to follow the provisions of Rev. Proc. 97–27, 1997–1 C.B. 680 (or its successor), as modified and amplified by Rev. Proc. 2002–19, as amplified and clarified by Rev. Proc. 2002–54, except that the scope limitations in section

4.02(2) through (6) of Rev. Proc. 97–27 do not apply to a bank that makes the change for either its first or second taxable year ending on or after December 31, 2006.

.03 If a bank with 6 or more years of collection experience wants to change its method of accounting for uncollected interest to the safe harbor method provided in SECTION 4 of this revenue procedure, the bank is required to follow the automatic change in method of accounting provisions of Rev. Proc. 2002–9 (or its successor), with the following modifications:

(1) the scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply to a bank that makes the change for either its first or second taxable year ending on or after December 31, 2006; and

(2) the designated automatic accounting change number for changes in method of accounting made pursuant to the revenue procedure is 108.

SECTION 7. REQUEST FOR COMMENTS

The Internal Revenue Service requests comments on this revenue procedure. In particular, comments are requested regarding the appropriate treatment of payments received in future years. For example, comments are requested regarding how to determine the portion, if any, of a payment attributable to amounts that the bank excluded from gross income. All comments should be submitted by August 20, 2007, to:

Internal Revenue Service
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:LPD:PRB (FIP)
Room 5529

Alternatively, comments may be submitted electronically directly to the Service via the following e-mail address: *Notice.comments@irscounsel.treas.gov*. Please include "Rev. Proc. 2007–33" in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective for tax years ending on or after its publication.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified and amplified to include the accounting method change provided by this revenue procedure.

DRAFTING INFORMATION

The principal author of this revenue procedure is Timothy Sebastian of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, contact Mr. Sebastian (202) 622–7417 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Under Section 2053 Regarding Post-Death Events

REG–143316–03

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations relating to the amount deductible from a decedent's gross estate for claims against the estate under section 2053(a)(3) of the Internal Revenue Code (Code). In addition, the proposed regulations update the provisions relating to the deduction for certain state death taxes to reflect the statutory amendments made in 2001 under sections 2053(d) and 2058. The proposed regulations will affect estates of decedents against whom there are claims outstanding at the time of the decedent's death. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 23, 2007. Outlines of topics to be discussed at the public hearing scheduled for August 6, 2007, at 10 a.m., must be received by July 30, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–143316–03), Room 5203, Internal Revenue Service, PO 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–143316–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC; or sent electronically via the Federal eRulemaking Portal at http://*www.regulations.gov* (IRS REG–143316–03). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, DeAnn K. Malone, at (202) 622–3112; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Richard Hurst, at (202) 622–2949 (TDD telephone) (not toll-free numbers) or e-mail at *Richard.A.Hurst@irscounsel.treas.gov*.

SUPPLEMENTARY INFORMATION:

Background

Section 2001 of the Code imposes a tax on the transfer of the taxable estate, determined as provided in section 2051, of every decedent, citizen, or resident of the United States. Section 2031(a) generally provides that the value of the decedent's gross estate shall include the value at the time of decedent's death of all property, real or personal, tangible or intangible, wherever situated. Section 2051 provides that the value of the taxable estate is determined by deducting from the value of the gross estate the deductions provided for in sections 2051 through 2058. Pursuant to section 2053(a), "the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts – (1) for funeral expenses, (2) for administration expenses, (3) for claims against the estate, and (4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate, as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered."

The deductions allowable under sections 2051 through 2058 operate to eliminate from estate taxation those portions of the gross estate that are necessarily expended in paying certain claims and expenses of the estate. The rationale for those deductions is that those expended portions of the gross estate are not transferred to the decedent's legatees, beneficiaries, or heirs and, therefore, are not subject to the transfer tax.

The amount an estate may deduct for claims against the estate has been a highly litigious issue. Unlike section 2031, section 2053(a) does not contain a specific directive to value a deductible claim at its date of death value. Section 2053, in fact, specifically contemplates expenses such as funeral and administration expenses, which are only determinable after the decedent's date of death. Although numerous courts have addressed section 2053(a)(3), there is little or no consistency among the conclusions of those courts with regard to the extent (if any) to which post-death events are to be considered in valuing such claims. One line of cases follows the decision in *Ithaca Trust v. Commissioner*, 279 U.S. 151 (1929), holding that the estate tax charitable deduction for a charitable remainder interest was to be determined as of date of death. In Federal judicial circuits where the *Ithaca Trust* date-of-death valuation approach is applied to a claim against a decedent's estate under section 2053(a)(3), courts generally hold that post-death events may not be considered when determining the amount deductible for that claim. At the opposite end of the spectrum, there is a line of cases that follows the Eighth Circuit's opinion in *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir. 1929), *cert. denied*, 280 U.S. 603 (1929), in which the court considered but rejected the date-of-death valuation approach in determining the deductible amount of a claim against the estate. The court in *Jacobs* distinguished *Ithaca Trust*, stating that, unlike charitable deductions, "…the claims which Congress intended to be deducted were actual claims, not theoretical ones." The court therefore held that only claims presented and determined as valid against the estate and actually paid could be deducted as claims against the estate. *Jacobs*, 34 F.2d at 235. The courts that follow *Jacobs* generally restrict the amount deductible under section 2053(a)(3) to amounts actually paid by the estate in satisfaction of the claim.

Even in the circuits where the date-of-death valuation approach has been applied in determining the amount that may be deducted for a claim against the decedent's estate, courts have recognized exceptions that necessitate taking into ac-

count events that occur after the decedent's death. For example, courts have deviated from the date-of-death valuation approach in favor of the actual payment approach when a claim is contested, contingent, unenforceable, becomes unenforceable after the decedent's death, or is not in fact presented for payment. The application and extent of these exceptions are inconsistent from circuit to circuit, however, and cannot be reconciled to form a conclusive rule applicable to all estates.

The result of this lack of consistency in the case law is that similarly situated estates are being treated differently for Federal estate tax purposes, depending only upon the jurisdiction in which the executor resides. The Treasury Department and the IRS believe that similarly situated estates should be treated consistently by having section 2053(a)(3) construed and applied in the same way in all jurisdictions.

One possible approach would be to value claims against a decedent's estate on the basis of the facts existing on the date of the decedent's death. The Treasury Department and the IRS believe, however, that this date-of-death valuation approach, when applied, has required an inefficient use of resources for taxpayers, the IRS, and the courts. Determining a date-of-death value requires the taxpayer and the IRS to retry the substantive issues underlying the claims against the estate in a tax controversy setting. In most cases, the tax controversy is addressed after the issue either has been settled by or has been argued by parties with adverse interests in a court of competent jurisdiction that is more familiar with the nuances of the underlying applicable law. Furthermore, this approach has proven to be expensive, both in terms of appraisal and litigation costs. In addition, this approach generally results in a deduction that is different from the amount actually paid on disputed claims. Finally, the date-of-death valuation approach often forces the taxpayer involved in actively defending against a claim to take contradictory positions on the estate tax return and in the substantive court pleadings, and may actually increase the taxpayer's potential liability.

After carefully considering the numerous judicial decisions and the analysis and conclusion in each, the legislative history of section 2053 and its predecessors, and the various possible alternatives, and in order to further the goal of the effective and fair administration of the tax laws, the proposed regulations adopt rules based on the premise that an estate may deduct under section 2053(a)(3) only amounts actually paid in settlement of claims against the estate. If the resolution of a contested or contingent claim cannot be reached prior to the expiration of the period of limitations for claims for refund, the estate may file a protective claim for refund to preserve its right to claim a deduction under section 2053(a).

Explanation of Provisions

The proposed regulations will amend the regulations under section 2053 to clarify that events occurring after a decedent's death are to be considered when determining the amount deductible under all provisions of section 2053 and that deductions under section 2053 are limited to amounts actually paid by the estate in satisfaction of deductible expenses and claims. Final court decisions as to the amount and enforceability of the claim or expense are accepted in determining the amount deductible if the court passes upon the facts upon which deductibility depends. Settlements are accepted if they are reached in *bona fide* negotiations between adverse parties with valid claims recognizable under applicable law, and if they are not inconsistent with the applicable law. A protective claim for refund may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's right to claim a refund if the amount of a liability will not be ascertainable by the time of the expiration of the period of limitations for claims of refund. A deduction is not allowed to the extent the expense or claim is compensated for by insurance or is otherwise reimbursed.

The proposed regulations further provide that no deduction may be taken on an estate tax return for a claim that is potential, unmatured, or contested at the time the return is filed. A protective claim for refund may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's right to claim a refund by reason of the deduction of a claim against the estate to the extent that claim is ultimately paid by the estate.

Additional provisions in the proposed regulations provide guidance for other particular circumstances. When a claim against an estate lists multiple defendants, the estate may only deduct the decedent's portion of the liability. Claims by family members or beneficiaries of a decedent's estate will be strictly scrutinized to ensure that they are legitimate claims. If a claim becomes unenforceable after the decedent's death, the estate may not take a section 2053(a)(3) deduction with respect to the claim. If a claim represents a decedent's obligation to make recurring payments that will likely continue for a period extending beyond the final determination of the estate tax liability, a deduction is allowed only as each payment is made, provided the period of limitations for claims for refund has not expired or the estate has properly preserved the claim for refund. Alternatively, a deduction is allowed for the cost of a commercial annuity purchased by the estate from an unrelated dealer in commercial annuities in satisfaction of that obligation.

Finally, the proposed regulations reflect changes made to section 2053(d) and the enactment of section 2058 in 2001 and clarify that the rules in section 20.2053–9 apply only to the estates of decedents dying on or before December 31, 2004.

Proposed Effective Date

The regulations, as proposed, apply to the estate of any decedent dying on or after the date final regulations are published in the **Federal Register**.

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for August 6, 2007, at 10 a.m. in the IRS Auditorium, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by July 16, 2007, and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by July 30, 2007. 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 DeAnn K. Malone, Office of the Chief Counsel, IRS.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 20 is proposed to be amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. Section 20.2051–1 is revised to read as follows:

§20.2051–1 Definition of taxable estate.

(a) The taxable estate of a decedent who was a citizen or resident (see §20.0–1(b)(1)(i)) of the United States at death is determined by subtracting the total amount of the deductions authorized by sections 2052 through 2058 from the total amount which must be included in the gross estate under sections 2031 through 2044. These deductions are in general as follows:

(1) An exemption of $60,000 (section 2052) (applicable only to the estates of decedents dying on or before December 31, 1976).

(2) Funeral and administration expenses and claims against the estate (including certain taxes and charitable pledges) (section 2053).

(3) Losses from casualty or theft during the administration of the estate (section 2054).

(4) Charitable transfers (section 2055).

(5) The marital deduction (section 2056).

(6) Qualified domestic trusts (section 2056A).

(7) Family-owned business interests (section 2057) (applicable only to the estates of decedents dying on or before December 31, 2003).

(8) State death taxes (section 2058) (applicable only to the estates of decedents dying after December 31, 2004).

(b) See section 2106 and these regulations for the computation of the taxable estate of a decedent who was not a citizen or resident of the United States. See also §1.642(g)–1 of this chapter concerning the disallowance for income tax purposes of certain deductions allowed for estate tax purposes.

(c) *Effective date*. The rules of this section apply to the estates of decedents dying on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 3. Section 20.2053–1 is amended by:

1. Revising the introductory text of paragraph (a).

2. Adding two new sentences at the end of paragraph (b)(1).

3. Revising paragraph (b)(2).

4. Redesignating paragraph (b)(3) as (b)(4) and revising the newly-designated paragraph (b)(4).

5. Adding new paragraphs (b)(3), (b)(5), (b)(6), and (e).

The revisions and additions read as follows:

§20.2053–1 Deductions for expenses, indebtedness, and taxes; in general.

(a) *General rule*. In determining the taxable estate of a decedent who was a citizen or resident of the United States at death, there are allowed as deductions under section 2053(a) and (b) amounts falling within the following two categories (subject to the limitations contained in this section and in §§20.2053–2 through 20.2053–10):

* * * * *

(b) * * * (1) * * * In order to properly take into account events occurring after the date of a decedent's death when determining the amount deductible against a decedent's estate, the deduction for any item described in paragraph (a) of this section is limited to the total amount actually paid (subject to any time requirement under paragraph (a) of this section) in settlement or satisfaction of that item. (See however, §20.2053–1(b)(4) for a special rule for deducting certain estimated amounts.)

(2) *Effect of court decree*—(i) *In general*. If the court with appropriate jurisdiction over the administration of the estate reviews and approves expenditures for funeral expenses, administration expenses, claims against the estate, or unpaid mortgages as allowable estate expenditures under local law, the executor may rely on the final judicial decision in that matter to determine the amount deductible for estate tax purposes if the following conditions are satisfied: the expenditures are otherwise deductible under section 2053 and the corresponding regulations; the expenditures have been paid by the estate or meet the requirements for estimated

expenses; the court reviewed the facts relating to the expenditures; and the court's decision is consistent with local law. See §20.2053–2 for additional rules regarding the deductibility of funeral expenses. See §20.2053–3 for additional rules regarding the deductibility of administration expenses. See §20.2053–4 for additional rules regarding the deductibility of claims against the estate. See §20.2053–7 for additional rules regarding the deductibility of unpaid mortgages. If the decision reached by the court is inconsistent with local law, the estate may not rely on the court's decree to establish the amount deductible for estate tax purposes. For example, a local court decree approving an allowance made to an executor in excess of the amount or limit prescribed by statute may not be relied upon to establish the amount deductible under section 2053. An estate will not be denied an otherwise allowable deduction under section 2053 solely because a local court decree has not been entered with respect to that amount if the amount would be allowable under local law and if no court decree is required under applicable law for payment.

(ii) *Consent decree*. An executor may rely on a local court decree rendered by consent to establish the amount deductible under section 2053 for amounts paid (or meeting the requirements for estimated expenses) if the consent was a *bona fide* recognition of the validity of the claim and was accepted by the court as satisfactory evidence upon the merits. Consent given by all parties having interests adverse to that of the claimant will be presumed to be recognition of the claim's validity. See §20.2053–4(b)(4) for special rules to determine the amount deductible for claims by decedent's family members, related entities, or beneficiaries of the decedent's estate or revocable trust.

(3) *Settlements*. An executor may rely on a settlement to establish the amount deductible under section 2053 for amounts paid (or meeting the requirements for estimated expenses) (subject to any applicable time limitation under paragraph (a) of this section) if the following conditions are satisfied: the settlement resolves a *bona fide* issue in an active and genuine contest; the settlement is the product of arm's length negotiations by parties having adverse interests with respect to the claim; and the settlement is within the range of reasonable outcomes under applicable state law governing the issues resolved by the settlement. A settlement that results in a compromise between the positions of such adverse parties and reflects the parties' assessments of the relative strengths of their respective positions is a settlement that is within the range of reasonable outcomes. However, a deduction for amounts paid in settlement of a claim against the decedent's estate will not be allowed if the terms of the settlement are inconsistent with applicable local law. No deduction will be allowed for amounts paid in settlement of an unenforceable claim. See §20.2053–4(b)(4) for special rules to determine the amount deductible for claims by decedent's family members, related entities, or beneficiaries of the decedent's estate or revocable trust. For settlements structured using recurring payments, see §20.2053–4(b)(7).

(4) *Estimated amounts*. A deduction will be allowed for a claim that satisfies all applicable requirements even though its exact amount is not then known, provided that the amount is ascertainable with reasonable certainty, and will be paid. Under this exception to the rule set forth in paragraph (b)(1) of this section, no deduction may be taken upon the basis of a vague or uncertain estimate. If a deduction is allowed in advance of payment and the payment is thereafter waived or otherwise left unpaid, it shall be the duty of the executor to notify the Commissioner and to pay the resulting tax, together with interest. To the extent that the amount of a liability otherwise deductible under section 2053 is not ascertainable with reasonable certainty at the time of examination of the return by the Commissioner, or to the extent that it is not then clear that the amount will be paid, that amount will not be allowed as a deduction by the Commissioner. If the deduction is disallowed in whole or in part on examination of the return and the amount of the liability is subsequently ascertained and paid, relief may be sought by a timely claim for refund as provided by section 6511. A protective claim for refund may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's right to claim a refund if the amount of a liability was or will not be paid before the expiration of the period of limitations for claims for refund. Although the protective claim need not state a particular dollar amount or demand an immediate refund, the protective claim must identify the outstanding liability or claim that would have been deductible under section 2053(a) had it already been paid. The protective claim must also describe the reasons and contingencies delaying the determination of the liability or the actual payment of the claim. Action on protective claims will proceed after the executor has notified the Commissioner that the contingency has been resolved.

(5) *Reimbursements*. A deduction is not allowed to the extent that the expense or claim is or could be compensated for by insurance or otherwise reimbursed.

(6) *Examples*. The following examples illustrate the application of this section. Assume that the amounts are payable out of property subject to claims and are allowable by the law of the jurisdiction governing the administration of the estate, whether the applicable jurisdiction is within or without the United States.

Example 1. Estimated amounts, deduction ascertainable. Decedent's (D's) estate was probated in state. State law provides that the personal representative shall receive compensation equal to 2.5 percent of the value of the probate estate. The executor (E) may claim a deduction for estimated fees equal to 2.5 percent of D's probate estate on the estate tax return filed for D's estate as an estimated amount, provided the amount will be paid to E after the estate tax return is filed. To the extent that, at the time of the examination of the return, the amount has not been paid and E cannot satisfy the conditions listed in paragraph (b)(4) of this section and §20.2053–3(b)(1), the deduction will be disallowed, but the executor may file a timely protective claim for refund to protect the estate's right to a refund once the amount has been paid or satisfies the applicable conditions. If the deduction is allowed in advance of payment and the payment is thereafter waived or otherwise left unpaid, it shall be the duty of the executor to notify the Commissioner and to pay the resulting tax, together with interest.

Example 2. Estimated amounts, deduction not ascertainable. Prior to death, Decedent (D) is sued by Claimant (C) for $100x in a tort proceeding and responds asserting affirmative defenses available to D under applicable local law. C and D are unrelated. D subsequently dies and D's Form 706 is due before a final judgment is entered in the case. The executor (E) of D's estate may not take a deduction for $100x on D's estate tax return as an estimated amount because the deductible amount cannot be ascertained with reasonable certainty in accordance with §20.2053–4(b)(2). If the amount of the actual liability will not be paid or cannot be ascertained with reasonable certainty before the expiration of the period of limitations for claims for refund, E may file a protective claim before that date in order to preserve the estate's right subsequently to claim a refund.

* * * * *

(e) *Effective date*. The rules of this section apply to the estates of decedents dying on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 4. Section 20.2053–3 is amended by:

1. Redesignating paragraphs (b)(2) and (b)(3) as paragraphs (b)(4) and (b)(5), respectively.

2. Designating the undesignated text following paragraph (b)(1) as new paragraph (b)(3).

3. Revising paragraphs (b)(1) and (c)(1).

4. Adding new paragraphs (b)(2), (d)(3) and (e).

The revisions and additions read as follows:

§20.2053–3 Deductions for expenses of administering estate.

* * * * *

(b) *Executor's commissions*. (1) The executor, in filing the estate tax return, may deduct executor's commissions in such an amount as has actually been paid, or in an amount which at the time of filing the estate tax return may reasonably be expected to be paid, but no deduction may be taken if no commissions are to be collected. If the amount of the commissions has not been fixed by decree of the proper court, the deduction will be allowed on the examination of the return, to the extent that all three of the following conditions are satisfied:

(i) The Commissioner is reasonably satisfied that the commissions claimed will be paid.

(ii) The amount claimed as a deduction is within the amount allowable by the laws of the jurisdiction in which the estate is being administered.

(iii) It is in accordance with the usually accepted practice in the jurisdiction to allow such an amount in estates of similar size and character.

(2) If the conditions described in paragraph (b)(1) of this section are not met, a protective claim for refund may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's right to claim a refund for future amounts paid as described in §20.2053–1(b)(4).

(3) If the deduction is disallowed in whole or in part on the examination of the return and a protective claim was timely filed, the disallowance will be subject to modification once the requirements for deductibility are met. If the deduction is allowed in advance of payment and payment is thereafter waived or otherwise left unpaid, it shall be the duty of the executor to notify the Commissioner and to pay the resulting tax, together with interest.

* * * * *

(c) *Attorney's fees*. (1) The executor, in filing the estate tax return, may deduct such an amount of attorney's fees as has actually been paid, or an amount which at the time of filing may reasonably be expected to be paid. If on the examination of the return, the fees claimed have not been awarded by the proper court and paid, the deduction will, nevertheless, be allowed, if the Commissioner is reasonably satisfied that the amount claimed will be paid and that it does not exceed a reasonable remuneration for the services rendered, taking into account the size and character of the estate and the local law and practice. If the amount does not satisfy these requirements, a protective claim for refund may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's right to claim a refund for future amounts paid as described in §20.2053–1(b)(4). If the deduction is disallowed in whole or in part on the examination of the return and a protective claim was timely filed, the disallowance will be subject to modification once the requirements for deductibility are met.

* * * * *

(d) * * *

(3) Expenses incurred in defending the estate against claims described in section 2053(a)(3) are deductible as provided in §20.2053–1 if the expenses are incurred incident to the assertion of defenses to the claim available under the applicable law, even if the estate is not ultimately victorious. For purposes of this section, "expenses incurred in defending the estate against claims" include costs relating to the arbitration and mediation of contested issues, costs associated with defending the estate against claims (whether or not enforceable), and costs associated with reaching a negotiated settlement of the issues. Expenses incurred merely for the purpose of unreasonably extending the time for payment, or incurred other than in good faith, are not deductible.

(e) Effective date. The rules of this section apply to the estates of decedents dying on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 5. Section 20.2053–4 is revised to read as follows:

§20.2053–4 Deduction for claims against the estate.

(a) *In general*. (1) For purposes of this section, liabilities imposed by law or arising out of contracts or torts are deductible if they meet the requirements set forth in §20.2053–1 and this section. Except as provided in paragraph (b) of this section, the amounts that may be deducted as claims against a decedent's estate are limited to amounts for legitimate and *bona fide* claims that—

(i) Represent personal obligations of the decedent existing at the time of the decedent's death;

(ii) Are enforceable against the decedent's estate at the time of payment; and

(iii) Are actually paid by the estate in settlement of the claim.

(2) Events occurring after the date of a decedent's death shall be considered when determining the amount deductible against a decedent's estate.

(b) *Special rules*—(1) *Potential and unmatured claims*. Claims that are unmatured on the date of the decedent's death and that later mature and are paid are deductible by the estate. However, no deduction may be taken on an estate tax return for a potential or unmatured claim. If the claim matures and is paid prior to the expiration of the period of limitations for filing a claim for refund, the estate may file a claim for refund as provided by section 6511. A protective claim for refund may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's right to claim a refund once the claim against the decedent's estate is matured and is paid or may be estimated as provided in §20.2053–1(b)(4). Although the protective claim need not state a particular dollar amount or demand an immediate refund, the protective claim must identify the outstanding liability or

claim that would have been deductible under section 2053(a) had it already been paid, and must describe the reasons and contingencies delaying actual payment of the liability or claim. Action on protective claims will proceed after the executor has notified the Commissioner that the contingency has been resolved.

(2) *Contested claims*. No deduction may be taken on an estate tax return for a claim against the decedent's estate to the extent the estate is contesting the decedent's liability. However, see §20.2053–1(b)(4) relating to estimated amounts.

(3) *Claims against multiple parties*. If the decedent or the decedent's estate is one of two or more parties against whom the claim is being asserted, the estate may only deduct the portion of the total claim due from and paid by the estate, reduced by the total of any reimbursement received from another party, insurance, or otherwise. The estate's deductible portion will also be reduced by the amount or contribution the estate could have collected from another party or an insurer but which the estate declines or fails to attempt to collect. If, however, the estate establishes that the burden of necessary collection efforts would have outweighed the benefit from those efforts, the potential reimbursement will not reduce the estate's deductible portion of the total claim. If the estate establishes that the party from whom a potential reimbursement could be collected could only pay a portion of the potential reimbursement, then only that portion that could reasonably have been expected to be collected will reduce the estate's deductible portion of the total claim.

(4) *Claims by family members, related entities, or beneficiaries*. Relationships with and among a decedent and the decedent's family members, related entities, and beneficiaries may create the potential for collusion in asserting invalid or exaggerated claims in order to reduce the decedent's taxable estate. Thus, notwithstanding §20.2053–1 and paragraph (a) of this section, there will be a rebuttable presumption that claims by a family member of the decedent, a related entity, or a beneficiary of the decedent's estate or revocable trust are not legitimate and *bona fide* and therefore are not deductible. Evidence sufficient to rebut the presumption may include evidence that the claim arises from circumstances that would reasonably support a similar claim by unrelated persons or non-beneficiaries. Similarly, a settlement between a decedent's estate or revocable trust and a family member, a related entity, or a beneficiary of the decedent's estate or revocable trust will be presumed to not be deductible absent evidence of the legitimacy and *bona fide* nature of the claim. For purposes of this section, family members include the spouse of the decedent; the grandparents, parents, siblings, and lineal descendants of the decedent or of the decedent's spouse; and the spouse and lineal descendants of any such grandparent, parent, and sibling. Family members include adopted individuals. For purposes of this section, a related entity is an entity in which the decedent, either directly or indirectly, had a beneficial ownership interest at the time of the decedent's death or at any time during the three-year period ending on the decedent's date of death. Such an entity, however, shall not include a publicly-traded entity nor shall it include a closely-held entity in which the combined beneficial interest, either direct or indirect, of the decedent and the decedent's family members, collectively, is less than thirty percent of the beneficial ownership interests (whether voting or non-voting).

(5) *Unenforceable claims*. Claims that are unenforceable prior to or at the decedent's death are not deductible, even if they are actually paid. Claims that become unenforceable during the administration of the estate are not deductible to the extent that they are paid after they become unenforceable. To the extent that enforceability of a claim is at issue, see paragraph (b)(2) of this section relating to contested claims.

(6) *Claims founded upon a promise*. Except with regard to pledges or subscriptions, (see §20.2053–5), section 2053(c)(1)(A) provides that the deduction for a claim founded upon a promise or agreement is limited to the extent that the promise or agreement was *bona fide* and in exchange for adequate and full consideration in money or money's worth. For this purpose, *bona fide* and for adequate and full consideration in money or money's worth requires that the promise or agreement must have been made in good faith, and that the price must have been an adequate and full equivalent reducible to a money value.

(7) *Recurring payments*—(i) *Non-Contingent obligations*. If a decedent is obligated to make recurring payments on an enforceable and certain claim that are not subject to a contingency and if the payments will continue for a period that will likely extend beyond the final determination of the estate tax liability, the obligation may be deducted as an estimated amount using the rules in §20.2053–1. The amount deductible is the present value of the payments on the decedent's date of death as determined under §20.2031–7(d). See §§20.7520–1 through 20.7520–4. If there is a reasonable likelihood that full satisfaction of the liability will not be made, then the obligation will be deemed to be subject to a contingency for purposes of this section.

(ii) *Contingent obligations*. If a decedent has a recurring obligation to pay an enforceable and certain claim, but the decedent's obligation is subject to a contingency or is otherwise not described in paragraph (b)(7)(i) of this section, the estate's deduction is limited to amounts actually paid by the estate in satisfaction of the claim.

(iii) *Purchase of commercial annuity to satisfy recurring obligation to pay*. If a decedent has a recurring obligation (whether or not contingent) to pay an enforceable and certain claim and the estate purchases a commercial annuity from an unrelated dealer in commercial annuities in an arms-length transaction to satisfy the obligation, the amount deductible by the estate is the sum of—

(A) The amount paid for the commercial annuity; and

(B) Any amount actually paid to the claimant by the estate prior to the purchase of the commercial annuity.

(c) *Interest on claims*. The interest on a deductible claim is itself deductible as a claim under section 2053, but only to the extent of the amount of interest accrued at the date of the decedent's death and actually paid, even if the executor elects the alternate valuation method under section 2032. (Post-death accrued interest may be deductible in appropriate circumstances either as an estate tax administration expense under section 2053 or as an income tax deduction.)

(d) *Examples*. The following examples illustrate the application of paragraphs (a) through (c) of this section. Except as is

otherwise provided in the examples, assume that the claimant (C) is not a family member, related entity or beneficiary of the decedent (D) and is not the executor (E). Assume that a claim represents a personal obligation of D existing at the time of D's death and is enforceable against D's estate. Assume that the payment of the claim, where applicable, is made out of property subject to claims (as defined in section 2053(c)(2) and §20.2053–1(c)(2)) and is allowable by the law of the jurisdiction under which the decedent's estate is being administered, or is paid prior to the filing of the estate tax return (including any extension granted under section 6081) from property not subject to claims. Assume that any court decree is based upon the facts upon which deductibility depends and is consistent with applicable local law. Assume that any settlement is reached in *bona fide* negotiations between or among parties having adverse interests with respect to the claim and that the terms of the settlement are not inconsistent with applicable local law.

Example 1. Contested claim, single defendant, no decision. D is sued by C for $100x in a tort proceeding and responds asserting affirmative defenses available to D under applicable local law. D dies and E is substituted as defendant in the suit. D's estate tax return is due before a judgment is reached in the case. D's gross estate includes only property subject to claims and exceeds $100x. E may not take a deduction on the return for the claim under section 2053(a)(3). A deduction may be claimed on the return, however, for expenses incurred prior to the filing of the estate tax return in defending the estate against the claim if the expenses have been paid in accordance with §20.2053–3(c) or (d)(3) or as an estimate under §20.2053–1(b)(4). E may file a protective claim for refund before the expiration of the period of limitations for claims for refund of the estate tax in order to preserve the estate's right to claim a refund if the amount of the liability will not be paid or cannot be ascertained with reasonable certainty by the expiration of that period of limitations. If payment is subsequently made pursuant to a court decision or a settlement, a deduction for the payment, as well as expenses incurred incident to the claim and not previously deducted, may be taken and relief may be sought by supplementing a previously filed protective claim or by filing a claim for refund as provided by section 6511.

Example 2. Contested claim, single defendant, final court decree and payment. The facts are the same as in *Example 1* except that, before the return is timely filed, the court enters a decision in favor of C, no timely appeal is filed, and payment is made. A deduction is allowed for the amount paid in satisfaction of the claim pursuant to the final decision of the local court, including any interest accrued prior to D's death, under section 2053(a)(3). In addition, a deduction may be available under §20.2053–3(d)(3) for expenses incurred prior to the filing of the estate tax return in defending the estate against the claim and in processing payment of the claim.

Example 3. Contested claim, single defendant, settlement and payment. The facts are the same as in *Example 1* except that, before the return is timely filed, a settlement is reached between D's estate and C for $80x and payment is made. A deduction is allowed for the amount of the settlement paid to C ($80x) under section 2053(a)(3). In addition, a deduction may be available under §20.2053–3(d)(3) for expenses incurred prior to the filing of the estate tax return in defending the estate, reaching a settlement, and processing payment of the claim.

Example 4. Contested claim, multiple defendants. The facts are the same as in *Example 1* except that the suit filed by C lists D and K, an unrelated third-party, as defendants. If the claim is not resolved prior to the time the estate tax return is filed, E may not take a deduction for the claim under section 2053(a)(3) on the return. If payment is subsequently made of D's share of the claim pursuant to a court decision or a settlement holding D liable for 40 percent of the amount due and K liable for 60 percent of the amount due, then the estate may take a deduction for the amount paid in satisfaction of the claim representing D's share of the liability as assigned by the court decree ($40x), plus any interest on that share accrued prior to D's death, under section 2053(a)(3). If the court decision finds D and K jointly and severally liable for the entire $100x and D's estate pays the entire $100x but could have reasonably collected $50x from K in reimbursement, the estate may take a deduction under section 2053(a)(3) and paragraph (b)(3) of this section for only $50x and the interest on $50x accrued prior to D's death. In both instances, a deduction may also be available under §20.2053–3(d)(3) for expenses incurred and not previously deducted in defending the estate against the claim and processing payment of the amount due from D.

Example 5. Contested claim, multiple defendants, settlement and payment. The facts are the same as in *Example 1* except that the suit filed by C lists D and K, an unrelated third-party, as defendants. D's estate settles with C for $10x and payment is made before the return is timely filed. E may take a deduction for the amount paid to C in satisfaction of the claim. In addition, a deduction may be available under §20.2053–3(d)(3) for expenses incurred prior to the filing of the estate tax return in defending the estate, reaching a settlement, and processing payment of the claim.

Example 6. Mixed claims. During life, D contracts with C to perform specific work on D's home for $75x. Under the contract, additional work must be approved in advance by D. C performs additional work and sues D for $100x for work completed including the $75x agreed to in the contract. D dies and D's estate tax return is due before a judgment is reached in the case. E contests liability for $25x. E may take a deduction on the return for $75x if it has been paid or if it meets the requirements of an estimated amount. In addition, a deduction may be claimed on the return for expenses incurred in defending the estate against the claim if they have been paid under §20.2053–3(c) or (d)(3) or as an estimate under §20.2053–1(b)(4). E may file a protective claim for refund before the expiration of the period of limitations on claims for refund of the estate tax in order to preserve the estate's right to claim a refund if payment on any amount in excess of $75x is subsequently made in resolution of a claim that would qualify for a deduction under section 2053. To the extent that the expenses incurred in defending the estate against the claim are not deducted as an estimate, they may be included in the protective claim for refund.

Example 7. Unenforceable claims. D is sued by C for $100x in a tort proceeding but the claim is barred by the applicable period of limitations and there is no other recourse available to C. A deduction is not allowed for the claim under section 2053(a)(3) whether or not the estate actually pays money in satisfaction of the claim. A deduction may be available, however, under §20.2053–3(d)(3) for expenses incurred in defending the estate against the claim.

Example 8. Non-contingent and recurring obligation to pay, binding on estate. D's property settlement agreement incident to D's divorce, signed three years prior to D's death, obligates D or D's estate to pay to S, D's former spouse, $20x per year for 10 years. The payments are not conditioned on whether or not S remarries. If S dies prior to the last payment, the terms of the agreement state that the remaining payments are to be made to S's estate or as S may appoint in S's will. Prior to filing D's estate tax return, D's estate pays the first of the 7 payments remaining as of D's death. The estate may take a deduction for the present value of these payments. See §§20.7520–1 through 20.7520–4.

Example 9. Contingent recurring obligation to pay, binding on estate. D's property settlement agreement incident to D's divorce, signed three years prior to D's death, obligates D or D's estate to pay to S, D's former spouse, $20x per year for 10 years. The obligation to make the annual payments ceases upon S's remarriage or S's death prior to the due date of the last payment. Prior to filing D's estate tax return, D's estate pays the first of the 7 payments remaining as of D's death. E may take as a deduction on the return the amount of the 1 payment made prior to the filing of D's estate tax return. Additional payments become deductible as they are paid. E may file a protective claim for refund before the expiration of the period of limitations for claims for refund of the estate tax in order to preserve the estate's right to claim a refund if the amount of the liability will not be paid or is not ascertainable with reasonable certainty by the expiration of the applicable period of limitations. If the total amount to be paid in satisfaction of the liability is not ascertainable with reasonable certainty at the time of examination of the return, relief may be sought by a claim for refund (either actual or protective) as provided by section 6511.

Example 10. Recurring obligation to pay, estate purchases a commercial annuity in satisfaction. D's property settlement agreement incident to D's divorce, signed three years prior to D's death, obligates D or D's estate to pay to S, D's former spouse, $20x per year for 10 years. D's estate purchases a commercial annuity from an unrelated dealer in commercial annuities, XYZ, in a *bona fide* sale to satisfy the obligation to S. E may deduct the entire amount paid to XYZ to obtain the annuity, regardless of whether or not the obligation to S was contingent.

(e) *Effective date.* The rules of this section apply to the estates of decedents dying on or after the date of publication of the

Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 6. Section 20.2053–6 is amended by revising paragraphs (a) and (c) and adding new paragraphs (g) and (h) to read as follows:

§20.2053–6 Deduction for taxes.

(a) *In general*. Taxes are deductible in computing a decedent's gross estate only as claims against the estate (except to the extent that excise taxes may be allowable as administration expenses), and only to the extent not disallowed by section 2053(c)(1)(B) (see the remaining paragraphs of this section). However, see §§20.2053–9 and 20.2053–10 with respect to the deduction allowed for certain state and foreign death taxes.

* * * * *

(c) *Death taxes*. (1) For the estates of decedents dying on or before December 31, 2004, no estate, succession, legacy or inheritance tax payable by reason of the decedent's death is deductible, except as provided in §20.2053–9 and §20.2053–10 with respect to certain state and foreign death taxes on transfers for charitable, etc., uses. However, see sections 2011 and 2014 and these regulations with respect to credits for death taxes.

(2) For the estates of decedents dying after December 31, 2004, see section 2058 to determine the deductibility of state death taxes.

* * * * *

(g) *Post-death adjustments of deductible tax liability*. Post-death adjustments increasing a tax liability accrued prior to the decedent's death, including increases of taxes deducted under this section, will increase the amount of the deduction taken under section 2053(a)(3) for that tax liability. Similarly, any refund subsequently determined to be due to and received by the estate with respect to taxes deducted by the estate under this section reduces the amount of the deduction taken for that tax liability under section 2053(a)(3). Expenses associated with defending the estate against the increase in tax liability or with obtaining the refund may be deductible under §20.2053–3(d)(3). A protective claim for refund of estate taxes may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's right to claim a refund if the amount of a deductible tax liability may be affected by such an adjustment or refund. The application of this section may be illustrated by the following examples:

Example 1. Increase in tax due. After the decedent's death, the Internal Revenue Service examines the gift tax return filed by the decedent in the year before the decedent's death and asserts a deficiency of $100x. The estate spends $30x in a non-frivolous defense against the increased deficiency. The final determination of the deficiency, in the amount of $90x, is paid by the estate. The estate may deduct $90x under section 2053(a)(3) and $30x under §20.2053–3(c)(2) or (d)(3).

Example 2. Refund of taxes paid. Decedent's estate timely files D's individual income tax return for the year in which the decedent died. The estate timely pays the entire amount of the tax due, $50x, as shown on that return. The entire $50x was attributable to income received prior to the decedent's death. Decedent's estate subsequently discovers an error on the income tax return and files a timely claim for refund. Decedent's estate receives a refund of $10x. The estate is only allowed a deduction of $40x under section 2053(a)(3) for the income tax liability accrued prior to the decedent's death. If a deduction for $50x was allowed on the estate tax return prior to the receipt of the refund, it shall be the duty of the executor to notify the Commissioner of the change and to pay the resulting tax, with interest.

(h) *Effective date*. The rules of this section apply to the estates of decedents dying on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 7. Section 20.2053–9 is amended as follows:

1. Revising the heading for paragraph (a) and adding a sentence at the end of paragraph (a).

2. Revising the first and last sentences of paragraph (c).

3. Adding new paragraph (f).

The revisions and addition read as follows:

§20.2053–9 Deduction for certain state death taxes.

(a) *General rules for the estates of decedents dying on or before December 31, 2004.** * * For the estates of decedents dying after December 31, 2004, see section 2058 to determine the deductibility of state death taxes.

* * * * *

(c) *Exercise of election*. The election to take a deduction for a state death tax imposed upon a transfer for charitable, etc., uses shall be exercised by the executor by the filing of a written notification to that effect with the Commissioner. * * * The election may be revoked by the executor by the filing of a written notification to that effect with the Commissioner at any time before the expiration of such period.

* * * * *

(f) *Effective date*. The rules of this section apply to the estates of decedents dying on or before December 31, 2004.

Par. 8. Section 20.2053–10 is amended by revising paragraph (c) and adding a new paragraph (e) to read as follows:

§20.2053–10 Deduction for certain foreign death taxes.

* * * * *

(c) *Exercise of election*. The election to take a deduction for a foreign death tax imposed upon a transfer for charitable, etc., uses shall be exercised by the executor by the filing of a written notification to that effect with the Commissioner. An election to take the deduction for foreign death taxes is deemed to be a waiver of the right to claim a credit under a treaty with any foreign country for any tax or portion thereof claimed as a deduction under this section. The notification shall be filed before the expiration of the period of limitations for assessment provided in section 6501 (usually 3 years from the last day for filing the return). The election may be revoked by the executor by the filing of a written notification to that effect with the Commissioner at any time before the expiration of such period.

* * * * *

(e) *Effective date*. The rules of this section apply to the estates of decedents dying on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

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

(Filed by the Office of the Federal Register on April 20, 2007, 8:45 a.m., and published in the issue of the Federal Register for April 23, 2007, 72 F.R. 20080)

Dual Consolidated Loss Regulations; Correction

Announcement 2007–49

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendments.

SUMMARY: This document contains corrections to final regulations (T.D. 9315, 2007–15 I.R.B. 891) that were published in the **Federal Register** on Monday, March 19, 2007 (72 FR 12902) regarding dual consolidated losses. Section 1503(d) generally provides that a dual consolidated loss of a dual resident corporation cannot reduce the taxable income of any other member of the affiliated group unless, to the extent provided in regulations, the loss does not offset the income of any foreign corporation.

DATES: These correcting amendments are effective April 25, 2007.

FOR FURTHER INFORMATION CONTACT: Jeffrey P. Cowan, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of this document are under section 1503(d) of the Internal Revenue Code.

Need for Correction

As published, final regulations (T.D. 9315) contain errors that may prove to be misleading and are in need of clarification.

* * * * *

Correction of Publication

Accordingly, 26 CFR part 1 is corrected by making the following correcting amendments:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.1503(d)–0 is amended by revising the entries (1) and (2) of Section 1.1503(d)–8(b). The revisions read as follows:

§1.1503(d)–0 Table of contents.

* * * * *

§1.1503(d)–8 Effective dates.

* * * * *

(b) * * *

(1) Reduction of term of agreements filed under §§1.1503–2A(c)(3), 1.1503–2A(d)(3), 1.1503–2(g)(2)(i), or 1.1503–2T(g)(2)(i).

(2) Reduction of term of agreements filed under §§1.1503–2(g)(2)(iv)(B)(*2*)(*i*) (1992), 1.1503–2(g)(2)(iv)(B)(*3*)(*i*), or Rev. Proc. 2000–42.

* * * * *

Par. 3. Section 1.1503(d)–5 is amended by revising the last sentence of paragraph (a), the second sentence of paragraph (c)(4)(i)(A), and the only sentence of paragraph (d) to read as follows:

§1.1503(d)–5 Attribution of items and basis adjustments.

(a) * * * The rules in this section apply for purposes of §§1.1503(d)–1 through 1.1503(d)–7.

* * * * *

(c) * * *

(4) * * *

(i) * * *

(A) * * * For purposes of determining items of income, gain, deduction, and loss of the domestic owner that are attributable to the domestic owner's foreign branch separate unit described in the preceding sentence, only items of income, gain, deduction, and loss that are attributable to the domestic owner's interest in the hybrid entity, or transparent entity, as provided in paragraph (c)(3) of this section, shall be taken into account. * * *

* * * * *

(d) * * * The fact that a particular item taken into account in computing the income or dual consolidated loss of a dual resident corporation or a separate unit, or the income or loss of an interest in a transparent entity, is not taken into account in computing income (or loss) subject to a foreign country's income tax shall not cause such item to be excluded from being taken into account under paragraph (b), (c), or (e) of this section.

* * * * *

Par. 4. Section 1.1503(d)–7(c) is amended by revising the last sentence of paragraph (iv) of *Example 5* and the last sentence of paragraph (C) of *Example 40*(ii).

The revisions read as follows:

§1.1503(d)–7 Examples.

* * * * *

(c) * * *

Example 5. * * *

(iv) * * * In addition, pursuant to §1.1503(d)–6(f)(1) and (3) , the deemed transfers pursuant to Rev. Rul. 99–5 as a result of the sale are not treated as triggering events described in §1.1503(d)–6(e)(1)(iv) or (v).

* * * * *

Example 40. * * *

(ii) * * *

(C) * * * Pursuant to §1.1503(d)–6(j)(1)(iii), the domestic use agreement filed by the P consolidated group with respect to the year 1 dual consolidated loss of the Country X separate unit is terminated and has no further effect.

* * * * *

Par. 5. Section 1.1503(d)–8 is amended by revising the heading texts of paragraphs (b)(1) and (2), the only sentence of paragraph (b)(1), the first sentence of paragraph (b)(2) and the last sentence of paragraph (b)(4).

The revisions read as follows:

§1.1503(d)–8 Effective dates.

* * * * *

(b) * * *

(1) *Reduction of term of agreements filed under §§1.1503–2A(c)(3), 1.1503–2A(d)(3), 1.1503–2(g)(2)(i), or 1.1503–2T(g)(i).* If an agreement is filed in accordance with §§1.1503–2A(c)(3), 1.1503–2A(d)(3), 1.1503–2(g)(2)(i), or 1.1503–2T(g)(2)(i) with respect to a dual consolidated loss incurred in a taxable year beginning prior to the application date and an event requiring recapture with respect to the dual consolidated loss subject to the agreement has not occurred as of the application date, then such agreement will be considered by the Internal Revenue Service to apply only for any taxable year up to and including the fifth taxable year following the year in which the dual consolidated loss that is the subject of the agreement was incurred and thereafter will have no effect.

(2) *Reduction of term of agreements filed under §§1.1503–2(g)(2)(iv)(B)(2)(i) (1992), 1.1503–2(g)(2)(iv)(B)(3)(i), or*

Rev. Proc. 2000–42. Taxpayers subject to the terms of a closing agreement entered into with the Internal Revenue Service pursuant to §§1.1503–2(g)(2)(iv)(B)(*2*)(*i*) (1992), 1.1503–2(g)(2)(iv)(B)(*3*)(*i*), or Rev. Proc. 2000–42, 2000–2 C.B. 394, see §601.601(d)(2)(ii)(*b*) of this chapter, will be deemed to have satisfied the closing agreement's fifteen-year certification period requirement if the five-year certification period specified in §1.1503(d)–1(b)(20) has elapsed, provided such closing agreement is still in effect as of the application date, and provided the dual consolidated losses have not been recaptured. * * *

* * * * *

(4) * * * Notwithstanding the general application of this paragraph (b)(4) to events described in §1.1503–2(g)(2)(iv)(B)(*1*)(*i*) through (*iii*) that occur after April 18, 2007, a taxpayer may choose to apply this paragraph (b)(4) to events described in §1.1503–2(g)(2)(iv)(B)(*1*)(*i*) through (*iii*) that occur after March 19, 2007 and on or before April 18, 2007.

* * * * *

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

(Filed by the Office of the Federal Register on April 24, 2007, 8:45 a.m., and published in the issue of the Federal Register for April 25, 2007, 72 F.R. 20423)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

Bulletins 2007–1 through 2007–21

Announcements:

Notices:

Proposed Regulations:

Proposed Regulations— Continued:

Revenue Procedures:

Revenue Rulings:

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2006–27 through 2006–52 is in Internal Revenue Bulletin 2006–52, dated December 26, 2006.

Finding List of Current Actions on Previously Published Items[1]

Bulletins 2007–1 through 2007–21

Announcements:

2006-45
Updated and superseded by
Ann. 2007-47, 2007-20 I.R.B. *1260*

Notices:

2002-45
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2005-1
Obsoleted in part by
T.D. 9321, 2007-19 I.R.B. *1123*

2005-29
Modified and superseded by
Notice 2007-4, 2007-2 I.R.B. *260*

2005-86
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2005-98
Modified and superseded by
Notice 2007-26, 2007-14 I.R.B. *870*

2006-2
Modified and superseded by
Notice 2007-4, 2007-2 I.R.B. *260*

2006-4
Superseded in part by
T.D. 9321, 2007-19 I.R.B. *1123*

2006-13
Obsoleted by
T.D. 9315, 2007-15 I.R.B. *891*

2006-50
Amplified, clarified, and modified by
Notice 2007-11, 2007-5 I.R.B. *405*

2006-64
Superseded for taxable years on or after January 1, 2008 by
T.D. 9321, 2007-19 I.R.B. *1123*

2006-77
Clarified, modified, and amplified by
Notice 2007-36, 2007-17 I.R.B. *1000*

2006-87
Modified and supplemented by
Notice 2007-25, 2007-12 I.R.B. *760*

2007-19
Amended and supplemented by
Notice 2007-31, 2007-16 I.R.B. *971*

Proposed Regulations:

REG-208270-86
Corrected by
Ann. 2007-4, 2007-7 I.R.B. *518*

REG-121509-00
Corrected by
Ann. 2007-17, 2007-8 I.R.B. *597*

REG-139059-02
Corrected by
Ann. 2007-36, 2007-15 I.R.B. *953*
Ann. 2007-37, 2007-15 I.R.B. *954*

REG-141901-05
Corrected by
Ann. 2007-7, 2007-4 I.R.B. *377*

REG-142270-05
Corrected by
Ann. 2007-2, 2007-2 I.R.B. *263*

REG-125632-06
Corrected by
Ann. 2007-26, 2007-10 I.R.B. *682*

REG-127819-06
Corrected by
Ann. 2007-5, 2007-4 I.R.B. *376*

REG-136806-06
Corrected by
Ann. 2007-6, 2007-4 I.R.B. *376*
Hearing cancelled by
Ann. 2007-19, 2007-7 I.R.B. *521*

Revenue Procedures:

98-20
Superseded by
Rev. Proc. 2007-12, 2007-4 I.R.B. *354*

2000-38
Modified by
Rev. Proc. 2007-16, 2007-4 I.R.B. *358*

2000-42
Obsoleted in part by
T.D. 9315, 2007-15 I.R.B. *891*

2000-50
Modified by
Rev. Proc. 2007-16, 2007-4 I.R.B. *358*

2001-31
Superseded by
Rev. Proc. 2007-29, 2007-17 I.R.B. *1004*

2001-42
Modified and amplified by
Rev. Proc. 2007-19, 2007-7 I.R.B. *515*

2002-9
Modified and amplified by
Rev. Proc. 2007-14, 2007-4 I.R.B. *357*

Revenue Procedures— Continued:

Rev. Proc. 2007-33, 2007-21 I.R.B. *1289*
Modified by
Rev. Proc. 2007-16, 2007-4 I.R.B. *358*

2004-11
Superseded by
Rev. Proc. 2007-16, 2007-4 I.R.B. *358*

2004-65
Modified and superseded by
Rev. Proc. 2007-20, 2007-7 I.R.B. *517*

2005-12
Superseded by
Rev. Proc. 2007-17, 2007-4 I.R.B. *368*

2005-51
Amplified by
Rev. Proc. 2007-25, 2007-12 I.R.B. *761*

2005-69
Superseded by
Rev. Proc. 2007-15, 2007-3 I.R.B. *300*

2005-74
Superseded by
Rev. Proc. 2007-24, 2007-11 I.R.B. *692*

2006-1
Superseded by
Rev. Proc. 2007-1, 2007-1 I.R.B. *1*

2006-2
Superseded by
Rev. Proc. 2007-2, 2007-1 I.R.B. *88*

2006-3
Superseded by
Rev. Proc. 2007-3, 2007-1 I.R.B. *108*

2006-4
Superseded by
Rev. Proc. 2007-4, 2007-1 I.R.B. *118*

2006-5
Superseded by
Rev. Proc. 2007-5, 2007-1 I.R.B. *161*

2006-6
Superseded by
Rev. Proc. 2007-6, 2007-1 I.R.B. *189*

2006-7
Superseded by
Rev. Proc. 2007-7, 2007-1 I.R.B. *227*

2006-8
Superseded by
Rev. Proc. 2007-8, 2007-1 I.R.B. *230*

2006-17
Obsoleted in part by
Rev. Proc. 2007-26, 2007-13 I.R.B. *814*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2006–27 through 2006–52 is in Internal Revenue Bulletin 2006–52, dated December 26, 2006.

Revenue Procedures— Continued:

2006-20
Obsoleted in part by
Rev. Proc. 2007-31, 2007-19 I.R.B. *1225*

2006-35
Modified by
Rev. Proc. 2007-22, 2007-10 I.R.B. *675*

Revenue Rulings:

54-19
Obsoleted in part by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

55-132
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

56-462
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

56-518
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

57-505
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

58-370
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

58-500
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

69-141
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

69-212
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

69-587
Revoked by
Rev. Rul. 2007-12, 2007-11 I.R.B. *685*

71-477
Obsoleted by
Rev. Rul. 2007-14, 2007-12 I.R.B. *747*

75-161
Obsoleted by
Rev. Rul. 2007-8, 2007-7 I.R.B. *469*

76-188
Obsoleted by
Rev. Rul. 2007-8, 2007-7 I.R.B. *469*

78-330
Modified by
Rev. Rul. 2007-8, 2007-7 I.R.B. *469*

Revenue Rulings— Continued:

81-18
Distinguished by
Rev. Rul. 2007-32, 2007-21 I.R.B. *1278*

81-225
Clarified and amplified by
Rev. Rul. 2007-7, 2007-7 I.R.B. *468*

92-19
Supplemented in part by
Rev. Rul. 2007-10, 2007-10 I.R.B. *660*

96-51
Amplified by
Rev. Rul. 2007-12, 2007-11 I.R.B. *685*

2002-41
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2003-43
Modified by
Notice 2007-2, 2007-2 I.R.B. *254*

2003-92
Clarified and amplified by
Rev. Rul. 2007-7, 2007-7 I.R.B. *468*

2003-102
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2003-109
Superseded by
Rev. Rul. 2007–28, 2007-18 I.R.B. *1039*

2005-24
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

2005-76
Supplemented and superseded by
Rev. Rul. 2007-4, 2007-4 I.R.B. *351*

2006-36
Modified by
Notice 2007-22, 2007-10 I.R.B. *670*

Treasury Decisions:

9263
Corrected by
Ann. 2007-22, 2007-9 I.R.B. *631*

9276
Corrected by
Ann. 2007-20, 2007-8 I.R.B. *599*
Ann. 2007-21, 2007-9 I.R.B. *630*

9278
Corrected by
Ann. 2007-9, 2007-5 I.R.B. *417*
Ann. 2007-10, 2007-6 I.R.B. *464*

9286
Corrected by
Ann. 2007-8, 2007-5 I.R.B. *416*

Treasury Decisions— Continued:

9298
Corrected by
Ann. 2007-32, 2007-11 I.R.B. *734*

9303
Corrected by
Ann. 2007-25, 2007-10 I.R.B. *682*

9313
Corrected by
Ann. 2007-48, 2007-20 I.R.B. *1274*

9315
Corrected by
Ann. 2007-49, 2007-21 I.R.B. *1300*

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