Internal Revenue
bulletin

Bulletin No. 2007-41
October 9, 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. 2007–62, page 767.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through December 2007. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through December 2007.

Rev. Rul. 2007–63, page 778.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for October 2007.

T.D. 9354, page 759.

Final regulations under section 21 of the Code conform the rules relating to the child and dependent care credit to statutory changes, including amendments under the Working Families Tax Relief Act of 2004, and address significant issues that have arisen administratively. The regulations are renumbered to conform to the renumbering of the statute. Rev. Ruls. 76–278 and 76–288 obsoleted.

T.D. 9357, page 773.

Final regulations under section 853 of the Code generally eliminate country-by-country reporting, by a regulated investment company (RIC) to its shareholders, of foreign source income that the RIC takes into account and foreign taxes that it pays.

T.D. 9358, page 769.

Final regulations under section 338 of the Code permit taxpayers to elect to modify the application of the ADSP and AGUB allocation rules of regulations section 1.338–6 as regards nuclear decommissioning funds that do not qualify under section 468A. The election is available in both section 338 and 1060 transactions (in a section 1060 transaction, the election affects allocation of amount realized and basis rather than ADSP and AGUB).

REG–143397–05, page 790.

Proposed regulations contain rules on the application of section 704(c)(1)(B) and 737 of the Code to distributions of property after two partnerships engage in an assets-over merger. The regulations provide that section 704(c)(1)(B) applies to newly created section 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over merger, but does not apply to newly created reverse section 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. They also provide that for purposes of section 737(b), net precontribution gain includes newly created section 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an asset-over merger, but does not include newly created reverse section 704(c) gain or loss resulting from a revaluation of property in the continuing partnership. A public hearing is scheduled for December 5, 2007.

Notice 2007–78, page 780.

This notice provides transition relief and additional guidance on the application of section 409A of the Code to nonqualified deferred compensation plans. The notice generally extends to December 31, 2008, the deadline to adopt documents that comply with section 409A, subject to limited requirements regarding the timely written designation of a time and form of payment. The notice also provides guidance addressing certain issues raised by the application to employment agreements and cashout features of section 409A and the final regulations, and the application of section 409A(b) to certain trusts and other arrangements to pay for nonqualified deferred compensation.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EMPLOYEE PLANS

Notice 2007–78, page 780.
This notice provides transition relief and additional guidance on the application of section 409A of the Code to nonqualified deferred compensation plans. The notice generally extends to December 31, 2008, the deadline to adopt documents that comply with section 409A, subject to limited requirements regarding the timely written designation of a time and form of payment. The notice also provides guidance addressing certain issues raised by the application to employment agreements and cashout features of section 409A and the final regulations, and the application of section 409A(b) to certain trusts and other arrangements to pay for nonqualified deferred compensation.

EXEMPT ORGANIZATIONS

Announcement 2007–89, page 798.
The IRS has revoked its determination that Vietnam Chinese Mutual Aid & Friendship Association of San Francisco, CA; Fairdale Athletic Club, Inc., of Louisville, KY; and Good Schools For All of San Francisco, CA, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

ADMINISTRATIVE

Rev. Proc. 2007–62, page 786.
This procedure supplements Rev. Proc. 2003–43 and Rev. Proc. 2004–48 and provides an additional simplified method for certain eligible entities to request relief for late S corporation elections and late entity classification elections. Rev. Procs. 2003–43 and 2004–48 supplemented.

Announcement 2007–84, page 797.
This document contains corrections to final and temporary regulations (T.D. 9332, 2007–32 I.R.B. 300) that relate to the exclusion from gross income of income derived by certain foreign corporations engaged in the international operation of ships or aircraft.

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 21.—Expenses for Household and Dependent Care Services Necessary for Gainful Employment

26 CFR 1.21–1: Expenses for household and dependent care services necessary for gainful employment.

T.D. 9354

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

Expenses for Household and Dependent Care Services Necessary for Gainful Employment

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the credit for expenses for household and dependent care services necessary for gainful employment. The regulations reflect statutory amendments under the Deficit Reduction Act of 1984, the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1987, the Family Support Act of 1988, the Small Business Job Protection Act of 1996, the Economic Growth and Tax Relief Reconciliation Act of 2001, the Job Creation and Worker Assistance Act of 2002, the Working Families Tax Relief Act of 2004, and the Gulf Opportunity Zone Act of 2005. The regulations affect taxpayers who claim the credit for expenses for household and dependent care services, and dependent care providers.

DATES: *Effective Date:* These regulations are effective August 14, 2007.

Applicability Date: For date of applicability, see §1.21–1(l).

FOR FURTHER INFORMATION CONTACT: Amy Pfalzgraf, (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final amendments to the Income Tax Regulations, 26 CFR part 1, relating to the credit for expenses for household and dependent care services necessary for gainful employment (the credit) under section 21 of the Internal Revenue Code (Code).

On May 24, 2006, a notice of proposed rulemaking (REG–139059–02, 2006–1 C.B. 1052) regarding the credit was published in the **Federal Register** (71 FR 29847). Written and electronic comments responding to the notice of proposed rulemaking were received. No public hearing was requested or held. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The comments and revisions are discussed in the preamble.

Explanation of Provisions and Summary of Comments

1. *Time of Payment and Performance of Services*

Section 21(b)(2) provides, in part, that employment-related expenses are amounts paid to enable a taxpayer to be gainfully employed for a period for which there are one or more qualifying individuals with respect to a taxpayer. The proposed regulations provide that a taxpayer may take expenses into account under section 21 only in the later of the taxable year the services are performed or the taxable year the expenses are paid. The proposed regulations also provide that the status of an individual as a qualifying individual is determined on a daily basis, that a taxpayer may take into account only expenses that qualify before a disqualifying event, such as a child turning 13, and that the requirements of section 21 and the regulations are applied at the time the services are performed, regardless of when the expenses are paid.

A verbal comment inquired whether, to be creditable, expenses must be paid and services must be performed before a disqualifying event.

The determination of whether expenses qualify as employment-related expenses, including whether an individual is a qualifying individual, can be made only at the time services are performed. Only expenses for the care of a qualifying individual that are for the purpose of enabling the taxpayer to be gainfully employed qualify for the credit. Therefore, services must be performed prior to a disqualifying event and at a time when the purpose is to enable the taxpayer to be gainfully employed. For purposes of determining whether expenses are employment-related expenses, the time of payment is irrelevant, although payment must be made before the credit is claimed. The final regulations provide examples to illustrate these rules.

2. *Care of Qualifying Individual and Household Services*

Under section 21(b)(2)(A), expenses are employment-related only if the expenses are primarily for household services or for the care of a qualifying individual. The proposed regulations provide that the primary purpose of expenses for the care of a qualifying individual must be to assure that individual's well-being and protection.

a. *Costs for education*

The proposed regulations provide that expenses for a child in nursery school, preschool, or similar programs for children below the kindergarten level are for the care of a qualifying individual and may be employment-related expenses. Expenses for a child in kindergarten or a higher grade are not for care and therefore, are not employment-related expenses. However, expenses for before- or after-school care of a child in kindergarten or a higher grade may be for care.

Commentators noted that some public school systems offer only half-day kindergarten, and that some parents send their children to private kindergarten because it offers a full-day program. Under the proposed regulations, a parent whose child attends a half-day kindergarten may claim the credit for the cost of an afternoon after-school program. However, a parent

whose child attends a full-day private kindergarten may not claim the credit for the cost of services performed in the afternoon, because the services are part of the kindergarten program and not after-school care. Commentators suggested that taxpayers who send their children to full-day private kindergarten should be allowed some apportionment of expenses for the afternoon portion of the kindergarten.

The final regulations do not adopt this comment. Kindergarten programs are primarily educational. See, for example, section 62(d)(1) (definitions of eligible educator and school) and section 530(b)(3)(B) (definition of school). Although nursery school and other programs below the level of kindergarten also may include significant educational elements, for administrative convenience the proposed regulations treat these programs as for care. The final regulations retain these rules for greater ease of administration.

A commentator suggested that amounts paid for sending a child to a private school by a taxpayer living overseas should be an employment-related expense if public education is not available. The final regulations do not adopt this comment. Employment-related expenses must be for the care of a qualifying individual and may not be for other services such as education.

b. *Specialty day camps*

The proposed regulations provide that the full amount paid for a day camp or similar program may be for the care of a qualifying individual although the camp specializes in a particular activity, such as soccer or computers. For administrative convenience, no allocation is required in this situation between the cost of care and amounts paid for learning a specialized skill.

A verbal comment requested that the regulations clarify that summer school is not day camp and that the cost of summer school is not creditable. Another commentator commended the proposed regulations for allowing the credit for the cost of "education day camps" that focus on reading, math, writing, and study skills.

The final regulations retain the rule that no allocation is required for the cost of a specialty day camp, but clarify that expenses for summer school and tutoring programs are not creditable. Summer school and tutoring programs are indistinguishable from school and are education, not care. The final regulations provide examples to illustrate these rules.

Section 21(b)(2)(C) provides, in part, that the cost of services performed by a dependent care center are employment-related expenses only if the dependent care center complies with the applicable laws of the state and local government. A commentator requested that the regulations clarify whether a day camp is a dependent care center and must comply with this requirement. The final regulations clarify that the requirements of section 21(b)(2)(C) apply to day camps that meet the definition of dependent care center in section 21(b)(2)(D).

c. *Sick child centers*

A commentator asserted that sick child centers that provide care for children with illnesses who cannot be cared for by the primary care provider primarily provide dependent care and that any medical care provided is incidental. The commentator suggested that these costs may be employment-related expenses.

The final regulations do not adopt this comment. A taxpayer may take an amount into account as either an employment-related expense under section 21 or an expense for medical care under section 213 (but not both). See section 213(e). Whether the care provided at a sick child center assures a child's well-being and protection or constitutes medical care is a factual matter that must be determined on a case-by-case basis.

d. *Boarding school*

The proposed regulations provide that an allocation must be made between expenses for the care of a qualifying individual and expenses for other goods or services, unless the other goods or services are incidental to and inseparably a part of the care. Specifically, amounts paid for food, lodging, clothing, or education are not for the care of a qualifying individual. The proposed regulations provide an example requiring a taxpayer to allocate the costs of a boarding school between care and education, meals, and housing.

A commentator stated that the example does not provide clear guidance for determining which expenses are for care and whether lodging and meals could be considered incidental and therefore, part of care. The commentator suggested that meals and lodging at a boarding school are incidental to and inseparably a part of the care provided.

The final regulations do not adopt this comment. The example and the regulations clearly distinguish care from food, lodging, and education provided by a boarding school, which are not for the care of a qualifying individual, or incidental to or inseparably a part of the care provided.

e. *Expenses for room and board of a caregiver*

The proposed regulations provide that the additional cost of providing room and board for a caregiver over usual household expenses may be an employment-related expense. This rule is based on Rev. Rul. 76–288, 1976–2 C.B. 83, which holds that under the predecessor to section 21, a taxpayer furnishing meals and lodging to a housekeeper who provides care may deduct the allocable expenses attributable to the housekeeper that are in addition to normal household expenses. The ruling provides an example allowing a taxpayer to take into account the additional cost of rent for an apartment with an additional bedroom to accommodate the housekeeper and additional utilities attributable to the housekeeper.

The proposed regulations provide that the general substantiation rules of section 6001 and the implementing regulations apply to taxpayers claiming the credit. A commentator stated that the regulations should clarify whether an increase in utilities (such as electric, water, and gas) may be employment-related expenses and what constitutes acceptable proof of costs.

The final regulations adopt the first of these comments and include an example similar to the example in Rev. Rul. 76–288. However, the final regulations do not provide special substantiation rules for these costs. These rules encompass substantiation of allocations by taxpayers claiming the credit with respect to the additional cost of providing room and board for a caregiver.

f. *Cost of overnight camp*

A commentator suggested that the credit should be allowed for a portion of the cost of overnight camp allocable to time when parents work. The final regulations do not adopt this comment. Under section 21(b)(2), the cost of overnight camp is not an employment-related expense.

3. *Expenses Enabling a Taxpayer to Be Gainfully Employed*

Under section 21(b)(2)(A), expenses are employment-related only if the taxpayer's purpose in obtaining the services is to enable the taxpayer to be gainfully employed. The expenses must be for periods during which the taxpayer is gainfully employed or is in active search of gainful employment.

a. *Short, temporary absence exception*

The proposed regulations provide that a taxpayer must allocate the cost of care on a daily basis if expenses are paid for a period during only part of which the taxpayer is employed or in active search of gainful employment. The proposed regulations provide an exception to the allocation requirement for a short, temporary absence from work for a taxpayer paying for dependent care on a weekly, monthly, or annual basis. Whether an absence is a short, temporary absence is determined based on all the facts and circumstances. The proposed regulations requested comments on an appropriate period to constitute a temporary absence safe harbor.

A commentator suggested that the exception for short, temporary absences should not be limited to taxpayers who pay employment-related expenses on a weekly, monthly, or annual basis. The commentator stated that regardless of payment schedule, taxpayers who take their children out of care due to a short illness or vacation typically must pay for that care when absent or risk losing it.

The final regulations adopt this comment and delete the provision that the temporary absence exception applies only to taxpayers who must pay for care on a weekly, monthly, or annual basis. The final regulations clarify, however, that only those costs that the taxpayer is required to pay during the absence qualify for the exception. The final regulations provide examples to illustrate these rules.

A commentator suggested that a length of absence that is less than a taxpayer's pay period should be deemed to be a short, temporary absence for that taxpayer, up to a maximum of 2 weeks. For example, the maximum short, temporary absence period of a taxpayer with a 1-week pay period would be 4 days. The final regulations do not adopt this comment, which would result in disparate treatment of taxpayers based on length of pay period.

A commentator suggested that the final regulations should adopt 12 weeks as a temporary absence safe harbor. The commentator based this suggestion on the Family Medical Leave Act (FMLA), which guarantees workers a maximum of 12 weeks of unpaid leave for the birth or adoption of a child and other purposes. The final regulations do not adopt this comment. Different policies underlie the FMLA and the dependent care credit. An absence of 12 weeks is not a short, temporary absence for purposes of claiming the credit.

The final regulations include a safe harbor that treats an absence of no more than 2 consecutive calendar weeks as a short, temporary absence, and modify the examples to illustrate this rule.

b. *Other costs*

A commentator suggested that the final regulations should clarify that expenses may be paid to enable a taxpayer to be gainfully employed and may be employment-related expenses if one parent works during the day and the other parent works at night, and the expenses are for care while one parent is working and the other is sleeping. Another commentator suggested that the cost of overnight care (not overnight camp) should be an employment-related expense for a taxpayer who works at night. The final regulations include examples illustrating that expenses may be employment-related expenses in these situations.

Commentators suggested that the cost of care should be treated as an employment-related expense for any period that a taxpayer is on short- or long-term disability, leave under the FMLA, paid medical leave, or paid maternity leave. The final regulations do not adopt these comments as these rules would be inconsistent with the statutory requirement that expenses are employment-related expenses only if paid to enable the taxpayer to be gainfully employed.

4. *Limitations on Amount Creditable*

a. *Dollar limit*

Commentators suggested that the dollar limit on employment-related expenses should be increased from $3,000 for one qualifying child and $6,000 for two or more qualifying children, to $5,000 for each qualifying child. The final regulations do not adopt these comments as they are inconsistent with the statutory limitations.

b. *Student at an educational organization*

For purposes of the deemed earned income of a spouse who is a full-time student, section 21(e)(7) and (8) defines *student* as an individual who, during each of 5 calendar months during the taxable year, is a full-time student at an educational organization described in section 170(b)(1)(A)(ii). Section 170(b)(1)(A)(ii) provides that an educational organization normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

A commentator suggested that a full-time student in an on-line degree program is a full-time student at an educational organization. The final regulations do not adopt this comment. A degree program offered by an organization that provides instruction exclusively over the internet (as opposed to an organization that provides courses on-line as well as traditional classroom instruction) does not have students in attendance at the place where its educational activities are regularly carried on and is not an educational organization within the meaning of section 170(b)(1)(A)(ii). Accordingly, an individual enrolled in a program provided by an organization that offers only on-line instruction is not a student for purposes of the deemed earned income rule. However, an individual who takes on-line courses at an organization that has traditional classroom instruction as well as on-line

courses, and that otherwise meets the definition of educational organization under section 170(b)(1)(A)(ii), may be a student for purposes of the deemed earned income rule.

The final regulations delete the cross-reference in the proposed regulations to the definition of student in section 152(f)(2) (for taxable years beginning after December 31, 2004) or section 151(c)(4) (for taxable years beginning before January 1, 2005), and the regulations thereunder, as that term is defined in section 21(e)(7) and (8) and these regulations.

5. *Substantiation*

The proposed regulations provide that taxpayers claiming a credit for employment-related expenses must maintain adequate records or other sufficient evidence to substantiate the expenses in accordance with section 6001 and the regulations thereunder.

A commentator suggested that dependent care assistance program administrators should be able to rely on the representations of plan participants, without additional documentation, to establish that indirect expenses are required and are subject to forfeiture, the proper expense allocation for part-time employees, and whether expenses are paid on a weekly or monthly basis. The final regulations do not adopt this comment as these situations do not present unusual substantiation issues.

6. *Conforming Changes*

The final regulations incorporate several changes to conform to amendments to the statute. The final regulations reflect that the special dependency rule of section 21(e)(5) applies to children of parents who live apart at all times during the last 6 months of the calendar year as well as to the children of separated or divorced parents. The final regulations reflect the changes made to the definitions of *qualifying individual* and *custodial parent* by the Gulf Opportunity Zone Act of 2005 (Public Law No. 109–135, 119 Stat. 2577). Finally, the final regulations clarify that, for taxable years beginning after December 31, 2004, costs for care outside the taxpayer's household of a qualifying individual who is a dependent or spouse incapable of self-care who regularly spends at least 8 hours each day in the taxpayer's household may continue to qualify for the credit.

7. *Effective Date*

The final regulations apply to taxable years ending after August 14, 2007.

Effect on Other Documents

Rev. Rul. 76–278, 1976–2 C.B. 84, and Rev. Rul. 76–288, 1976–2 C.B. 83, are obsoleted as of August 14, 2007.

Special Analyses

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

Drafting Information

The principal author of these regulations is Amy Pfalzgraf of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Department of the Treasury participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART I — INCOME TAXES

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

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

Section 1.21–1 also issued under 26 U.S.C. 21(f).

Section 1.21–2 also issued under 26 U.S.C. 21(f).

Section 1.21–3 also issued under 26 U.S.C. 21(f).

Section 1.21–4 also issued under 26 U.S.C. 21(f) * * *

§1.21–1 [Redesignated as §1.15–1]

Par. 2. Section 1.21–1 is redesignated §1.15–1.

Par. 3. New §§1.21–1, 1.21–2, 1.21–3, and 1.21–4 are added to read as follows:

§1.21–1 Expenses for household and dependent care services necessary for gainful employment.

(a) *In general.* (1) Section 21 allows a credit to a taxpayer against the tax imposed by chapter 1 for employment-related expenses for household services and care (as defined in paragraph (d) of this section) of a qualifying individual (as defined in paragraph (b) of this section). The purpose of the expenses must be to enable the taxpayer to be gainfully employed (as defined in paragraph (c) of this section). For taxable years beginning after December 31, 2004, a qualifying individual must have the same principal place of abode (as defined in paragraph (g) of this section) as the taxpayer for more than one-half of the taxable year. For taxable years beginning before January 1, 2005, the taxpayer must maintain a household (as defined in paragraph (h) of this section) that includes one or more qualifying individuals.

(2) The amount of the credit is equal to the applicable percentage of the employment-related expenses that may be taken into account by the taxpayer during the taxable year (but subject to the limits prescribed in §1.21–2). *Applicable percentage* means 35 percent reduced by 1 percentage point for each $2,000 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds $15,000, but not less than 20 percent. For example, if a taxpayer's adjusted gross income is $31,850, the applicable percentage is 26 percent.

(3) Expenses may be taken as a credit under section 21, regardless of the taxpayer's method of accounting, only in the taxable year the services are performed or the taxable year the expenses are paid, whichever is later.

(4) The requirements of section 21 and §§1.21–1 through 1.21–4 are applied at the time the services are performed, regardless of when the expenses are paid.

(5) *Examples*. The provisions of this paragraph (a) are illustrated by the following examples.

Example 1. In December 2007, B pays for the care of her child for January 2008. Under paragraph (a)(3) of this section, B may claim the credit in 2008, the later of the years in which the expenses are paid and the services are performed.

Example 2. The facts are the same as in *Example 1*, except that B's child turns 13 on February 1, 2008, and B pays for the care provided in January 2008 on February 3, 2008. Under paragraph (a)(4) of this section, the determination of whether the expenses are employment-related expenses is made when the services are performed. Assuming other requirements are met, the amount B pays will be an employment-related expense under section 21, because B's child is a qualifying individual when the services are performed, even though the child is not a qualifying individual when B pays the expenses.

(b) *Qualifying individual*—(1) *In general*. For taxable years beginning after December 31, 2004, a qualifying individual is—

(i) The taxpayer's dependent (who is a qualifying child within the meaning of section 152) who has not attained age 13;

(ii) The taxpayer's dependent (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B)) who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year; or

(iii) The taxpayer's spouse who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year.

(2) *Taxable years beginning before January 1, 2005*. For taxable years beginning before January 1, 2005, a qualifying individual is—

(i) The taxpayer's dependent for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(c) and who is under age 13;

(ii) The taxpayer's dependent who is physically or mentally incapable of self-care; or

(iii) The taxpayer's spouse who is physically or mentally incapable of self-care.

(3) *Qualification on a daily basis*. The status of an individual as a qualifying individual is determined on a daily basis. An individual is not a qualifying individual on the day the status terminates.

(4) *Physical or mental incapacity*. An individual is physically or mentally incapable of self-care if, as a result of a physical or mental defect, the individual is incapable of caring for the individual's hygiene or nutritional needs, or requires full-time attention of another person for the individual's own safety or the safety of others. The inability of an individual to engage in any substantial gainful activity or to perform the normal household functions of a homemaker or care for minor children by reason of a physical or mental condition does not of itself establish that the individual is physically or mentally incapable of self-care.

(5) *Special test for divorced or separated parents or parents living apart*—(i) *Scope*. This paragraph (b)(5) applies to a child (as defined in section 152(f)(1) for taxable years beginning after December 31, 2004, and in section 151(c)(3) for taxable years beginning before January 1, 2005) who—

(A) Is under age 13 or is physically or mentally incapable of self-care;

(B) Receives over one-half of his or her support during the calendar year from one or both parents who are divorced or legally separated under a decree of divorce or separate maintenance, are separated under a written separation agreement, or live apart at all times during the last 6 months of the calendar year; and

(C) Is in the custody of one or both parents for more than one-half of the calendar year.

(ii) *Custodial parent allowed the credit*. A child to whom this paragraph (b)(5) applies is the qualifying individual of only one parent in any taxable year and is the qualifying child of the custodial parent even if the noncustodial parent may claim the dependency exemption for that child for that taxable year. See section 21(e)(5). The custodial parent is the parent having custody for the greater portion of the calendar year. See section 152(e)(4)(A).

(6) *Example*. The provisions of this paragraph (b) are illustrated by the following example.

Example. C pays $420 for the care of her child, a qualifying individual, to be provided from January 2 through January 31, 2008 (21 days of care). On January 20, 2008, C's child turns 13 years old. Under paragraph (b)(3) of this section, C's child is a qualifying individual from January 2 through January 19, 2008 (13 days of care). C may take into account $260, the *pro rata* amount C pays for the care of her child for 13 days, under section 21. See §1.21–2(a)(4).

(c) *Gainful employment*—(1) *In general*. Expenses are employment-related expenses only if they are for the purpose of enabling the taxpayer to be gainfully employed. The expenses must be for the care of a qualifying individual or household services performed during periods in which the taxpayer is gainfully employed or is in active search of gainful employment. Employment may consist of service within or outside the taxpayer's home and includes self-employment. An expense is not employment-related merely because it is paid or incurred while the taxpayer is gainfully employed. The purpose of the expense must be to enable the taxpayer to be gainfully employed. Whether the purpose of an expense is to enable the taxpayer to be gainfully employed depends on the facts and circumstances of the particular case. Work as a volunteer or for a nominal consideration is not gainful employment.

(2) *Determination of period of employment on a daily basis*—(i) *In general*. Expenses paid for a period during only part of which the taxpayer is gainfully employed or in active search of gainful employment must be allocated on a daily basis.

(ii) *Exception for short, temporary absences*. A taxpayer who is gainfully employed is not required to allocate expenses during a short, temporary absence from work, such as for vacation or minor illness, provided that the care-giving arrangement requires the taxpayer to pay for care during the absence. An absence of 2 consecutive calendar weeks is a short, temporary absence. Whether an absence longer than 2 consecutive calendar weeks is a short, temporary absence is determined based on all the facts and circumstances.

(iii) *Part-time employment*. A taxpayer who is employed part-time generally must allocate expenses for dependent care between days worked and days not worked. However, if a taxpayer employed part-time is required to pay for dependent care on a periodic basis (such as weekly or monthly) that includes both days worked and days not worked, the taxpayer is not required to allocate the expenses. A day on which the taxpayer works at least 1 hour is a day of work.

(3) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. D works during the day and her husband, E, works at night and sleeps during the day. D and E pay for care for a qualifying individual during the hours when D is working and E is sleeping. Under paragraph (c)(1) of this section, the amount paid

by D and E for care may be for the purpose of allowing D and E to be gainfully employed and may be an employment-related expense under section 21.

Example 2. F works at night and pays for care for a qualifying individual during the hours when F is working. Under paragraph (c)(1) of this section, the amount paid by F for care may be for the purpose of allowing F to be gainfully employed and may be an employment-related expense under section 21.

Example 3. G, the custodial parent of two children who are qualifying individuals, hires a housekeeper for a monthly salary to care for the children while G is gainfully employed. G becomes ill and as a result is absent from work for 4 months. G continues to pay the housekeeper to care for the children while G is absent from work. During this 4-month period, G performs no employment services, but receives payments under her employer's wage continuation plan. Although G may be considered to be gainfully employed during her absence from work, the absence is not a short, temporary absence within the meaning of paragraph (c)(2)(ii) of this section, and her payments for household and dependent care services during the period of illness are not for the purpose of enabling her to be gainfully employed. G's expenses are not employment-related expenses, and she may not take the expenses into account under section 21.

Example 4. To be gainfully employed, H sends his child to a dependent care center that complies with all state and local requirements. The dependent care center requires payment for days when a child is absent from the center. H takes 8 days off from work as vacation days. Because the absence is less than 2 consecutive calendar weeks, under paragraph (c)(2)(ii) of this section, H's absence is a short, temporary absence. H is not required to allocate expenses between days worked and days not worked. The entire fee for the period that includes the 8 vacation days may be an employment-related expense under section 21.

Example 5. J works 3 days per week and her child attends a dependent care center (that complies with all state and local requirements) to enable her to be gainfully employed. The dependent care center allows payment for any 3 days per week for $150 or 5 days per week for $250. J enrolls her child for 5 days per week, and her child attends the care center for 5 days per week. Under paragraph (c)(2)(iii) of this section, J must allocate her expenses for dependent care between days worked and days not worked. Three-fifths of the $250, or $150 per week, may be an employment-related expense under section 21.

Example 6. The facts are the same as in *Example 5*, except that the dependent care center does not offer a 3-day option. The entire $250 weekly fee may be an employment-related expense under section 21.

(d) *Care of qualifying individual and household services*—(1) *In general*. To qualify for the dependent care credit, expenses must be for the care of a qualifying individual. Expenses are for the care of a qualifying individual if the primary function is to assure the individual's well-being and protection. Not all expenses relating to a qualifying individual are for the individual's care. Amounts paid for food, lodging, clothing, or education are not for the care of a qualifying individual. If, however, the care is provided in such a manner that the expenses cover other goods or services that are incidental to and inseparably a part of the care, the full amount is for care.

(2) *Allocation of expenses*. If an expense is partly for household services or for the care of a qualifying individual and partly for other goods or services, a reasonable allocation must be made. Only so much of the expense that is allocable to the household services or care of a qualifying individual is an employment-related expense. An allocation must be made if a housekeeper or other domestic employee performs household duties and cares for the qualifying children of the taxpayer and also performs other services for the taxpayer. No allocation is required, however, if the expense for the other purpose is minimal or insignificant or if an expense is partly attributable to the care of a qualifying individual and partly to household services.

(3) *Household services*. Expenses for household services may be employment-related expenses if the services are performed in connection with the care of a qualifying individual. The household services must be the performance in and about the taxpayer's home of ordinary and usual services necessary to the maintenance of the household and attributable to the care of the qualifying individual. Services of a housekeeper are household services within the meaning of this paragraph (d)(3) if the services are provided, at least in part, to the qualifying individual. Such services as are performed by chauffeurs, bartenders, or gardeners are not household services.

(4) *Manner of providing care*. The manner of providing care need not be the least expensive alternative available to the taxpayer. The cost of a paid caregiver may be an expense for the care of a qualifying individual even if another caregiver is available at no cost.

(5) *School or similar program*. Expenses for a child in nursery school, preschool, or similar programs for children below the level of kindergarten are for the care of a qualifying individual and may be employment-related expenses. Expenses for a child in kindergarten or a higher grade are not for the care of a qualifying individual. However, expenses for before- or after-school care of a child in kindergarten or a higher grade may be for the care of a qualifying individual.

(6) *Overnight camps*. Expenses for overnight camps are not employment-related expenses.

(7) *Day camps*. (i) The cost of a day camp or similar program may be for the care of a qualifying individual and an employment-related expense, without allocation under paragraph (d)(2) of this section, even if the day camp specializes in a particular activity. Summer school and tutoring programs are not for the care of a qualifying individual and the costs are not employment-related expenses.

(ii) A day camp that meets the definition of *dependent care center* in section 21(b)(2)(D) and paragraph (e)(2) of this section must comply with the requirements of section 21(b)(2)(C) and paragraph (e)(2) of this section.

(8) *Transportation*. The cost of transportation by a dependent care provider of a qualifying individual to or from a place where care of that qualifying individual is provided may be for the care of the qualifying individual. The cost of transportation not provided by a dependent care provider is not for the care of the qualifying individual.

(9) *Employment taxes*. Taxes under sections 3111 (relating to the Federal Insurance Contributions Act) and 3301 (relating to the Federal Unemployment Tax Act) and similar state payroll taxes are employment-related expenses if paid in respect of wages that are employment-related expenses.

(10) *Room and board*. The additional cost of providing room and board for a caregiver over usual household expenditures may be an employment-related expense.

(11) *Indirect expenses*. Expenses that relate to, but are not directly for, the care of a qualifying individual, such as application fees, agency fees, and deposits, may be for the care of a qualifying individual and may be employment-related expenses if the taxpayer is required to pay the expenses to obtain the related care. However, forfeited deposits and other payments are not for the care of a qualifying individual if care is not provided.

(12) *Examples*. The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. To be gainfully employed, K sends his 3-year old child to a pre-school. The pre-school provides lunch and snacks. Under paragraph (d)(1) of this section, K is not required to allocate expenses between care and the lunch and snacks, because the lunch and snacks are incidental to and inseparably a part of the care. Therefore, K may treat the full amount paid to the pre-school as for the care of his child.

Example 2. L, a member of the armed forces, is ordered to a combat zone. To be able to comply with the orders, L places her 10-year old child in boarding school. The school provides education, meals, and housing to L's child in addition to care. Under paragraph (d)(2) of this section, L must allocate the cost of the boarding school between expenses for care and expenses for education and other services not constituting care. Only the part of the cost of the boarding school that is for the care of L's child is an employment-related expense under section 21.

Example 3. To be gainfully employed, M employs a full-time housekeeper to care for M's two children, aged 9 and 13 years. The housekeeper regularly performs household services of cleaning and cooking and drives M to and from M's place of employment, a trip of 15 minutes each way. Under paragraph (d)(3) of this section, the chauffeur services are not household services. M is not required to allocate a portion of the expense of the housekeeper to the chauffeur services under paragraph (d)(2) of this section, however, because the chauffeur services are minimal and insignificant. Further, no allocation under paragraph (d)(2) of this section is required to determine the portion of the expenses attributable to the care of the 13-year old child (not a qualifying individual) because the household expenses are in part attributable to the care of the 9-year old child. Accordingly, the entire expense of employing the housekeeper is an employment-related expense. The amount that M may take into account as an employment-related expense under section 21, however, is limited to the amount allowable for one qualifying individual.

Example 4. To be gainfully employed, N sends her 9-year old child to a summer day camp that offers computer activities and recreational activities such as swimming and arts and crafts. Under paragraph (d)(7)(i) of this section, the full cost of the summer day camp may be for care.

Example 5. To be gainfully employed, O sends her 9-year old child to a math tutoring program for two hours per day during the summer. Under paragraph (d)(7)(i) of this section, the cost of the tutoring program is not for care.

Example 6. To be gainfully employed, P hires a full-time housekeeper to care for her 8-year old child. In order to accommodate the housekeeper, P moves from a 2-bedroom apartment to a 3-bedroom apartment that otherwise is comparable to the 2-bedroom apartment. Under paragraph (d)(10) of this section, the additional cost to rent the 3-bedroom apartment over the cost of the 2-bedroom apartment and any additional utilities attributable to the housekeeper's residence in the household may be employment-related expenses under section 21.

Example 7. Q pays a fee to an agency to obtain the services of an au pair to care for Q's children, qualifying individuals, to enable Q to be gainfully employed. An au pair from the agency subsequently provides care for Q's children. Under paragraph (d)(11) of this section, the fee may be an employment-related expense.

Example 8. R places a deposit with a pre-school to reserve a place for her child. R sends the child to a different pre-school and forfeits the deposit. Under paragraph (d)(11) of this section, the forfeited deposit is not an employment-related expense.

(e) *Services outside the taxpayer's household*—(1) *In general*. The credit is allowable for expenses for services performed outside the taxpayer's household only if the care is for one or more qualifying individuals who are described in this section at—

(i) Paragraph (b)(1)(i) or (b)(2)(i); or

(ii) Paragraph (b)(1)(ii), (b)(2)(ii), (b)(1)(iii), or (b)(2)(iii) and regularly spend at least 8 hours each day in the taxpayer's household.

(2) *Dependent care centers*—(i) *In general*. The credit is allowable for services performed by a dependent care center only if—

(A) The center complies with all applicable laws and regulations, if any, of a state or local government, such as state or local licensing requirements and building and fire code regulations; and

(B) The requirements provided in this paragraph (e) are met.

(ii) *Definition*. The term *dependent care center* means any facility that provides full-time or part-time care for more than six individuals (other than individuals who reside at the facility) on a regular basis during the taxpayer's taxable year, and receives a fee, payment, or grant for providing services for the individuals (regardless of whether the facility is operated for profit). For purposes of the preceding sentence, a facility is presumed to provide full-time or part-time care for six or fewer individuals on a regular basis during the taxpayer's taxable year if the facility has six or fewer individuals (including the taxpayer's qualifying individual) enrolled for full-time or part-time care on the day the qualifying individual is enrolled in the facility (or on the first day of the taxable year the qualifying individual attends the facility if the qualifying individual was enrolled in the facility in the preceding taxable year) unless the Internal Revenue Service demonstrates that the facility provides full-time or part-time care for more than six individuals on a regular basis during the taxpayer's taxable year.

(f) *Reimbursed expenses*. Employment-related expenses for which the taxpayer is reimbursed (for example, under a dependent care assistance program) may not be taken into account for purposes of the credit.

(g) *Principal place of abode*. For purposes of this section, the term *principal place of abode* has the same meaning as in section 152.

(h) *Maintenance of a household*—(1) *In general*. For taxable years beginning before January 1, 2005, the credit is available only to a taxpayer who maintains a household that includes one or more qualifying individuals. A taxpayer maintains a household for the taxable year (or lesser period) only if the taxpayer (and spouse, if applicable) occupies the household and furnishes over one-half of the cost for the taxable year (or lesser period) of maintaining the household. The household must be the principal place of abode for the taxable year of the taxpayer and the qualifying individual or individuals.

(2) *Cost of maintaining a household*. (i) Except as provided in paragraph (h)(2)(ii) of this section, for purposes of this section, the term *cost of maintaining a household* has the same meaning as in §1.2–2(d) without regard to the last sentence thereof.

(ii) The cost of maintaining a household does not include the value of services performed in the household by the taxpayer or by a qualifying individual described in paragraph (b) of this section or any expense paid or reimbursed by another person.

(3) *Monthly proration of annual costs*. In determining the cost of maintaining a household for a period of less than a taxable year, the cost for the entire taxable year must be prorated on the basis of the number of calendar months within that period. A period of less than a calendar month is treated as a full calendar month.

(4) *Two or more families*. If two or more families occupy living quarters in common, each of the families is treated as maintaining a separate household. A taxpayer is maintaining a household if the taxpayer provides more than one-half of the cost of maintaining the separate household. For example, if two unrelated taxpayers with their respective children occupy living quarters in common and each taxpayer pays more than one-half of the household costs for each respective family, each taxpayer is treated as maintaining a household.

(i) Reserved.

(j) *Expenses qualifying as medical expenses*—(1) *In general*. A taxpayer may not take an amount into account as both an employment-related expense under section 21 and an expense for medical care under section 213.

(2) *Examples*. The provisions of this paragraph (j) are illustrated by the following examples:

Example 1. S has $6,500 of employment-related expenses for the care of his child who is physically incapable of self-care. The expenses are for services performed in S's household that also qualify as expenses for medical care under section 213. Of the total expenses, S may take into account $3,000 under section 21. S may deduct the balance of the expenses, or $3,500, as expenses for medical care under section 213 to the extent the expenses exceed 7.5 percent of S's adjusted gross income.

Example 2. The facts are the same as in *Example 1*, however, S first takes into account the $6,500 of expenses under section 213. S deducts $500 as an expense for medical care, which is the amount by which the expenses exceed 7.5 percent of his adjusted gross income. S may not take into account the $6,000 balance as employment-related expenses under section 21, because he has taken the full amount of the expenses into account in computing the amount deductible under section 213.

(k) *Substantiation*. A taxpayer claiming a credit for employment-related expenses must maintain adequate records or other sufficient evidence to substantiate the expenses in accordance with section 6001 and the regulations thereunder.

(l) *Effective/applicability date*. This section and §§1.21–2 through 1.21–4 apply to taxable years ending after August 14, 2007.

§1.21–2 Limitations on amount creditable.

(a) *Annual dollar limitation*. (1) The amount of employment-related expenses that may be taken into account under §1.21–1(a) for any taxable year cannot exceed—

(i) $2,400 ($3,000 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there is one qualifying individual with respect to the taxpayer at any time during the taxable year; or

(ii) $4,800 ($6,000 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there are two or more qualifying individuals with respect to the taxpayer at any time during the taxable year.

(2) The amount determined under paragraph (a)(1) of this section is reduced by the aggregate amount excludable from gross income under section 129 for the taxable year.

(3) A taxpayer may take into account the total amount of employment-related expenses that do not exceed the annual dollar limitation although the amount of employment-related expenses attributable to one qualifying individual is disproportionate to the total employment-related expenses. For example, a taxpayer with expenses in 2007 of $4,000 for one qualifying individual and $1,500 for a second qualifying individual may take into account the full $5,500.

(4) A taxpayer is not required to prorate the annual dollar limitation if a qualifying individual ceases to qualify (for example, by turning age 13) during the taxable year. However, the taxpayer may take into account only amounts that qualify as employment-related expenses before the disqualifying event. See also §1.21–1(b)(6).

(b) *Earned income limitation*—(1) *In general*. The amount of employment-related expenses that may be taken into account under section 21 for any taxable year cannot exceed—

(i) For a taxpayer who is not married at the close of the taxable year, the taxpayer's earned income for the taxable year; or

(ii) For a taxpayer who is married at the close of the taxable year, the lesser of the taxpayer's earned income or the earned income of the taxpayer's spouse for the taxable year.

(2) *Determination of spouse*. For purposes of this paragraph (b), a taxpayer must take into account only the earned income of a spouse to whom the taxpayer is married at the close of the taxable year. The spouse's earned income for the entire taxable year is taken into account, however, even though the taxpayer and the spouse were married for only part of the taxable year. The taxpayer is not required to take into account the earned income of a spouse who died or was divorced or separated from the taxpayer during the taxable year. See §1.21–3(b) for rules providing that certain married taxpayers legally separated or living apart are treated as not married.

(3) *Definition of earned income*. For purposes of this section, the term *earned income* has the same meaning as in section 32(c)(2) and the regulations thereunder.

(4) *Attribution of earned income to student or incapacitated spouse*. (i) For purposes of this section, a spouse is deemed, for each month during which the spouse is a full-time student or is a qualifying individual described in §1.21–1(b)(1)(iii) or (b)(2)(iii), to be gainfully employed and to have earned income of not less than—

(A) $200 ($250 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there is one qualifying individual with respect to the taxpayer at any time during the taxable year; or

(B) $400 ($500 for taxable years beginning after December 31, 2002, and before January 1, 2011) if there are two or more qualifying individuals with respect to the taxpayer at any time during the taxable year.

(ii) For purposes of this paragraph (b)(4), a full-time student is an individual who, during each of 5 calendar months of the taxpayer's taxable year, is enrolled as a student for the number of course hours considered to be a full-time course of study at an educational organization as defined in section 170(b)(1)(A)(ii). The enrollment for 5 calendar months need not be consecutive.

(iii) Earned income may be attributed under this paragraph (b)(4), in the case of any husband and wife, to only one spouse in any month.

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

Example 1. In 2007, T, who is married to U, pays employment-related expenses of $5,000 for the care of one qualifying individual. T's earned income for the taxable year is $40,000 and her husband's earned income is $2,000. T did not exclude any dependent care assistance under section 129. Under paragraph (b)(1) of this section, T may take into account under section 21 only the amount of employment-related expenses that does not exceed the lesser of her earned income or the earned income of U, or $2,000.

Example 2. The facts are the same as in *Example 1* except that U is a full-time student at an educational organization within the meaning of section 170(b)(1)(A)(ii) for 9 months of the taxable year and has no earned income. Under paragraph (b)(4) of this section, U is deemed to have earned income of $2,250. T may take into account $2,250 of employment-related expenses under section 21.

Example 3. For all of 2007, V is a full-time student and W, V's husband, is an individual who is incapable of self-care (as defined in §1.21–1(b)(1)(iii)). V and W have no earned income and pay expenses of $5,000 for W's care. Under paragraph (b)(4) of this section, either V or W may be deemed to have $3,000 of earned income. However, earned income may be attributed to only one spouse under paragraph

(b)(4)(iii) of this section. Under the limitation in paragraph (b)(1)(ii) of this section, the lesser of V's and W's earned income is zero. V and W may not take the expenses into account under section 21.

(d) *Cross-reference*. For an additional limitation on the credit under section 21, see section 26.

§1.21–3 Special rules applicable to married taxpayers.

(a) *Joint return requirement*. No credit is allowed under section 21 for taxpayers who are married (within the meaning of section 7703 and the regulations thereunder) at the close of the taxable year unless the taxpayer and spouse file a joint return for the taxable year. See section 6013 and the regulations thereunder relating to joint returns of income tax by husband and wife.

(b) *Taxpayers treated as not married*. The requirements of paragraph (a) of this section do not apply to a taxpayer who is legally separated under a decree of divorce or separate maintenance or who is treated as not married under section 7703(b) and the regulations thereunder (relating to certain married taxpayers living apart). A taxpayer who is treated as not married under this paragraph (b) is not required to take into account the earned income of the taxpayer's spouse for purposes of applying the earned income limitation on the amount of employment-related expenses under §1.21–2(b).

(c) *Death of married taxpayer*. If a married taxpayer dies during the taxable year and the survivor may make a joint return with respect to the deceased spouse under section 6013(a)(3), the credit is allowed for the year only if a joint return is made. If, however, the surviving spouse remarries before the end of the taxable year in which the deceased spouse dies, a credit may be allowed on the decedent spouse's separate return.

§1.21–4 Payments to certain related individuals.

(a) *In general*. A credit is not allowed under section 21 for any amount paid by the taxpayer to an individual—

(1) For whom a deduction under section 151(c) (relating to deductions for personal exemptions for dependents) is allowable either to the taxpayer or the taxpayer's spouse for the taxable year;

(2) Who is a child of the taxpayer (within the meaning of section 152(f)(1) for taxable years beginning after December 31, 2004, and section 151(c)(3) for taxable years beginning before January 1, 2005) and is under age 19 at the close of the taxable year;

(3) Who is the spouse of the taxpayer at any time during the taxable year; or

(4) Who is the parent of the taxpayer's child who is a qualifying individual described in §1.21–1(b)(1)(i) or (b)(2)(i).

(b) *Payments to partnerships or other entities*. In general, paragraph (a) of this section does not apply to services performed by partnerships or other entities. If, however, the partnership or other entity is established or maintained primarily to avoid the application of paragraph (a) of this section to permit the taxpayer to claim the credit, for purposes of section 21, the payments of employment-related expenses are treated as made directly to each partner or owner in proportion to that partner's or owner's ownership interest. Whether a partnership or other entity is established or maintained to avoid the application of paragraph (a) of this section is determined based on the facts and circumstances, including whether the partnership or other entity is established for the primary purpose of caring for the taxpayer's qualifying individual or providing household services to the taxpayer.

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

Example 1. During 2007, X pays $5,000 to her mother for the care of X's 5-year old child who is a qualifying individual. The expenses otherwise qualify as employment-related expenses. X's mother is not her dependent. X may take into account under section 21 the amounts paid to her mother for the care of X's child.

Example 2. Y is divorced and has custody of his 5-year old child, who is a qualifying individual. Y pays $6,000 during 2007 to Z, who is his ex-wife and the child's mother, for the care of the child. The expenses otherwise qualify as employment-related expenses. Under paragraph (a)(4) of this section, Y may not take into account under section 21 the amounts paid to Z because Z is the child's mother.

Example 3. The facts are the same as in *Example 2*, except that Z is not the mother of Y's child. Y may take into account under section 21 the amounts paid to Z.

§§1.44A–1 through 1.44A–4 [Removed]

Par. 4. Sections 1.44A–1, 1.44A–2, 1.44A–3, and 1.44A–4 are removed.

§1.214–1 [Removed]

Par. 5. Section 1.214–1 is removed.

§§1.214A–1 through 1.214A–5 [Removed]

Par. 6. Sections 1.214A–1, 1.214A–2, 1.214A–3, 1.214A–4, and 1.214A–5 are removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In §602.101, paragraph (b) is amended to remove entries 1.44A–1 and 1.44A–3.

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

Approved August 2, 2007.

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

(Filed by the Office of the Federal Register on August 13, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 14, 2007, 72 F.R. 45338)

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through December 2007. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through December 2007.

Rev. Rul. 2007–62

In Rev. Rul. 90–60, 1990–2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of

bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of bond factor amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11, 1999–1 C.B. 275, established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of the low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period January through December 2007.

Table 1
Rev. Rul. 2007–62
Monthly Bond Factor Amounts for Dispositions Expressed As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Jan '07	17.39	32.44	45.52	56.97	66.95	69.23	71.86	74.74	78.09	81.82	85.82
Feb '07	17.39	32.44	45.52	56.97	66.95	69.08	71.70	74.56	77.89	81.60	85.57
Mar '07	17.39	32.44	45.52	56.97	66.95	68.92	71.53	74.39	77.71	81.40	85.33
Apr '07	17.39	32.44	45.52	56.97	66.95	68.77	71.37	74.22	77.52	81.19	85.11
May '07	17.39	32.44	45.52	56.97	66.95	68.62	71.22	74.05	77.35	81.00	84.89
Jun '07	17.39	32.44	45.52	56.97	66.95	68.47	71.06	73.89	77.17	80.81	84.68
Jul '07	17.39	32.44	45.52	56.97	66.95	68.32	70.91	73.74	77.01	80.63	84.47
Aug '07	17.39	32.44	45.52	56.97	66.95	68.18	70.76	73.58	76.84	80.45	84.28
Sep '07	17.39	32.44	45.52	56.97	66.95	68.04	70.62	73.43	76.68	80.27	84.09
Oct '07	17.39	32.44	45.52	56.97	66.95	67.90	70.48	73.28	76.53	80.11	83.90
Nov '07	17.39	32.44	45.52	56.97	66.95	67.77	70.34	73.14	76.37	79.94	83.73
Dec '07	17.39	32.44	45.52	56.97	66.95	67.63	70.20	73.00	76.22	79.78	83.56

Table 1 (cont'd)
Rev. Rul. 2007–62
Monthly Bond Factor Amounts for Dispositions Expressed As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	2004	2005	2006	2007							
Jan '07	89.79	93.41	96.70	97.21							
Feb '07	89.50	93.07	96.27	97.21							
Mar '07	89.22	92.75	95.89	97.21							
Apr '07	88.96	92.46	95.57	97.21							
May '07	88.72	92.18	95.28	97.21							
Jun '07	88.48	91.93	95.02	97.21							
Jul '07	88.25	91.69	94.79	97.21							
Aug '07	88.04	91.46	94.58	97.21							
Sep '07	87.83	91.25	94.39	97.21							

Table 1 (cont'd)
Rev. Rul. 2007–62
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	2004	2005	2006	2007							
Oct '07	87.64	91.05	94.22	97.21							
Nov '07	87.45	90.87	94.07	97.21							
Dec '07	87.27	90.69	93.92	97.21							

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3, 1998–1 C.B. 248; Rev. Rul. 2001–2, 2001–1 C.B. 255; Rev. Rul. 2001–53, 2001–2 C.B. 488; Rev. Rul. 2002–72, 2002–2 C.B. 759; Rev. Rul. 2003–117, 2003–2 C.B. 1051; Rev. Rul. 2004–100, 2004–2 C.B. 718; Rev. Rul. 2005–67, 2005–2 C.B. 771; and Rev. Rul. 2006–51, 2006–2 C.B. 632.

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 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 338.—Certain Stock Purchases Treated as Asset Acquisitions

26 CFR 1.338–6: Allocation of ADSP and AGUB among target assets.

T.D. 9358

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Treatment of Certain Nuclear Decommissioning Funds for Purposes of Allocating Purchase Price in Certain Deemed and Actual Asset Acquisitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the allocation of purchase price in certain deemed and actual asset acquisitions under sections 338 and 1060. These regulations affect sellers and purchasers of nuclear power plants or of the stock of corporations that own nuclear power plants.

DATES: *Effective Date:* These regulations are effective September 11, 2007.

Applicability Date: For dates of applicability, see §§1.338–6(c)(5)(vi) and 1.1060–1(e)(1)(ii)(C)(*4*).

FOR FURTHER INFORMATION CONTACT: Richard Starke at (202) 622–7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 16, 2004, the IRS and Treasury Department issued a notice of proposed rulemaking (REG–169135–03, 2004–2 C.B. 697) and temporary regulations (T.D. 9158, 2004–2 C.B. 665) in the **Federal Register** (69 FR 55740), modifying regulations under sections 338 and 1060 of the Internal Revenue Code (Code). The text of the temporary regulations was identical to the text of the proposed regulations.

Sections 338 and 1060 and the regulations thereunder provide a methodology by which the purchase or sales price in certain actual and deemed asset acquisitions is computed and allocated among the assets acquired or treated as acquired. The regime employs a residual method of allocation that divides assets into seven classes and allocates the consideration to each of the first six classes in turn, up to the fair market value of the assets in the class. The residual amount is allocated to assets in the last class.

The purchase price generally includes liabilities of the seller that are assumed by the purchaser. Those liabilities, however, must be treated as having been incurred by the purchaser. In order to be treated as having been incurred by the purchaser, in addition to other requirements, economic performance must have occurred with respect to the liability.

In connection with the sale of a nuclear power plant, the assets sold by the seller and purchased by the purchaser may in-

clude the plant, equipment, operating assets, and one or more funds holding assets that have been set aside for the purpose of satisfying the owner's responsibility to decommission the nuclear power plant after the conclusion of its useful life (the decommissioning liability), and the purchaser may have agreed to satisfy the decommissioning liability. One or more of such funds may not be a fund described in section 468A. Such other funds are referred to as nonqualified funds. Contributions to nonqualified funds do not give rise to a deduction in the year of contribution. In addition, the assets of a nonqualified fund continue to be treated as assets of the contributor.

The preamble to the proposed and temporary regulations concluded that the decommissioning liability will not satisfy the economic performance test until decommissioning occurs, and therefore that, as of the purchase date, it is not included in the purchase price that the purchaser allocates to the acquired assets. As a result, as of the purchase date, the purchase price to be allocated by the purchaser among the acquired assets may be significantly less than the fair market value of those assets. This situation will generally persist until economic performance with respect to the decommissioning liability is satisfied through decommissioning.

Generally under the residual method, the purchase price is allocated to the nonqualified fund's assets, which are typically Class I and Class II assets, before it is allocated to the plant, equipment, and other operating assets, which are typically Class V assets. Because the purchase price does not reflect the decommissioning liability and is first allocated to the assets of the nonqualified fund, the purchase price allocated to the plant, equipment, and other operating assets may be less than their fair market value. To the extent the purchase price allocated to the plant, equipment, and other operating assets is less than their fair market value, the purchaser will not recover a tax benefit (that is, a depreciation deduction) for the decommissioning liability until economic performance occurs on decommissioning.

To mitigate the tax effect of these decommissioning liabilities' not satisfying the statutory requirements for economic performance as to the purchaser, the temporary regulations added §1.338–6T. That regulation provides that, for purposes of allocating purchase or sales price among the acquisition date assets of a target, a taxpayer may irrevocably elect to treat a nonqualified fund as if such fund were an entity classified as a corporation the stock of which were among the acquisition date assets of the target and a Class V asset. In these cases, for allocation purposes, the hypothetical subsidiary corporation is treated as bearing the responsibility for decommissioning to the extent assets of the fund are expected to be used for that purpose. A section 338(h)(10) election is treated as made for the hypothetical subsidiary corporation (regardless of whether the requirements for a section 338(h)(10) election are otherwise satisfied).

The election converts the assets of the nonqualified fund from primarily Class I and Class II assets into stock of a hypothetical subsidiary corporation which is a Class V asset and allows the present cost of the decommissioning liability funded by the nonqualified fund, which otherwise cannot be taken into account for income tax purposes, to be netted against the fund assets for the sole purpose of valuing the stock of the hypothetical subsidiary corporation. Therefore, if the election is made, it is expected that a larger amount of the initial purchase price would be available to be allocated to the plant and other operating assets than if no such election had been made. However, in such a case, a much smaller amount of the initial purchase price would be available to be allocated to the assets of the nonqualified fund. Accordingly, a disposition of the nonqualified fund assets would likely result in current gain recognition.

Explanation of Provisions and Summary of Comments

A number of comments on the proposed regulations were received, the most significant of which are discussed below. No public hearing was requested nor held.

Economic Performance Test

The preamble to the proposed and temporary regulations discussed application of the economic performance test of section 461 to the assumption of decommissioning liabilities by the purchaser. Various commentators requested that, with respect to the purchaser of a nuclear power plant, the economic performance rules outlined in the proposed and temporary regulations be modified to provide that economic performance with respect to an assumed decommissioning liability be deemed to occur at the time of purchase rather than upon performance of the decommissioning activities. Specifically, commentators pointed out that the election in the proposed and temporary regulations will typically result in the purchaser holding the assets of the nonqualified fund with little or no tax basis, and subsequent investment reallocations undertaken during the course of portfolio management will result in gain recognition and a current tax liability. Further, the commentators noted that nonqualified trust agreements related to nuclear decommissioning obligations often require the trustees to remit to the purchasers, out of trust assets, the monies necessary to pay the purchasers' taxes resulting from the trusts' sales of assets. The commentators expressed concern that this requirement will result in fewer assets in the trust to be used to decommission the nuclear power plant because trustees will be required to either remit taxes from the fund or restrict changes in the fund's investment portfolio.

The IRS and Treasury Department recognize that requiring the purchaser to satisfy the economic performance of a liability assumed in a purchase transaction can result in the deferral of the basis of the acquired assets in the hands of the purchaser. However, this result is not unique to the assumption of decommissioning liabilities and therefore, the economic performance concerns raised by commentators extend beyond the scope of these regulations. The final regulations adopt the rules provided in the proposed and temporary regulations which are consistent with the application of economic performance rules of section 461 to liabilities assumed by a purchaser.

The Deemed Section 338(h)(10) Election

Several of the commentators urge that, if the IRS and Treasury Department decline to change the position on economic performance, then the final regulations should eliminate the particular result of the §1.338–6T(c)(5) election set forth in §1.338–6T(c)(5)(i)(E). That provision deems a section 338(h)(10) election to be made with respect to the hypothetical

subsidiary corporation that results from making the §1.338–6T(c)(5) election. The deemed section 338(h)(10) election operates to eliminate any carryover of the historic basis in the assets in the nonqualified decommissioning fund from the seller to the buyer. The commentators maintain that, as a substitute for the §1.338–6T(c)(5) election, the parties to the transaction could preserve the historic basis in the assets in the nonqualified fund by having the seller incorporate the nonqualified fund in a new subsidiary with the subsidiary assuming the appropriate portion of the decommissioning obligation long before the sale of the nuclear power plant.

However, simply eliminating the deemed section 338(h)(10) election that results from making the §1.338–6T(c)(5) election would not necessarily result in the same tax consequences to the parties as a transaction in which the seller incorporated the nonqualified fund in a new subsidiary prior to the sale of the nuclear power plant. The purchase of a subsidiary as opposed to an assumption of the decommissioning liability generally would result in tax accounting differences not only to the buyer but also the seller. Eliminating the deemed section 338(h)(10) election that results from making the §1.338–6T(c)(5) election would have the effect of essentially accelerating economic performance with respect to an assumed nuclear decommissioning liability in a manner inconsistent with the economic performance rules of other assumed liabilities. Therefore, the final regulations adopt the deemed section 338(h)(10) election rule as provided in §1.338–6T(c)(5)(i)(E).

Another group of commentators urge that the §1.338–6T(c)(5) election be made retroactively available prior to September 15, 2004. The allocation rules applicable under sections 338 and 1060 prior to September 15, 2004, however, were comprehensive, and the manner in which they operated was well known to participants in the nuclear power industry. Section 1.338–6T(c)(5) originally was proposed with a prospective effective date, and, while the members of the nuclear power industry at that time urged that §1.338–6T(c)(5) be made available retroactively, the IRS and Treasury Department declined to do so because transactions negotiated prior to September 15, 2004, would have been based on the rules of §1.338–6 without inclusion of §1.338–6T(c)(5). Although the commentators state that the nuclear power industry is very competitive and that some purchasers who purchased nuclear power plants prior to September 15, 2004, might be at a disadvantage relative to those who purchased on or after September 15, 2004, these final regulations are only applicable prospectively so as not to retroactively alter the tax consequences of prior transactions.

Finally, one commentator notes that §1.338–6T(c)(5)(i)(D) treats the hypothetical subsidiary corporation as bearing responsibility for decommissioning only to the extent that assets of the fund are expected to be used for that purpose (the expected use standard). The commentator argues that proving the expected use of the nonqualified assets might be a contentious issue and prove difficult. The commentator proposes that, for purposes of clarity, the hypothetical subsidiary corporation should be treated as bearing the responsibility for decommissioning in an amount equal to the fair market value of the nonqualified fund assets at the time of the closing of the transaction (causing the stock of the hypothetical subsidiary corporation to be assigned a zero value). The commentator suggests that such an approach would eliminate the uncertainty contained in the expected use standard and ensure that no portion of the purchase price is allocated to the nonqualified assets.

The IRS and Treasury Department believe, however, that the implementation of an approach that does not establish a connection between the fund assets and their expected use may lead to the over funding of nonqualified funds in certain circumstances and inappropriate allocations of basis. Accordingly, the final regulations retain the expected use standard.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and pursuant to 5 U.S.C. 553(d)(3) it has been determined that a delayed effective date is unnecessary because this rule finalizes currently effective temporary rules regarding the treatment of certain nuclear decommissioning funds for purposes of allocating purchase price in certain acquisitions without substantive change. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will affect sellers and purchasers of nuclear power plants or the stock of corporations that own nuclear power plants in qualified stock purchases, which tend to be larger businesses. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Richard Starke, Office of the Associate Chief Counsel (Corporate).

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for sections 1.338–6T and 1.1060–1T.

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

Par. 2. Section 1.338–0 is amended by removing the entry in the list of captions for §1.338–6T and by revising the entry in the list of captions for paragraph (c)(5) of §1.338–6 to read as follows:

§1.338–0 Outline of topics.

* * * * *

§1.338–6 Allocation of ADSP and AGUB among target assets.

* * * * *

(c) * * *

(5) Allocation to certain nuclear decommissioning funds.

* * * * *

Par. 3. Paragraph (c)(5) of §1.338–6 is amended to read as follows:

§1.338–6 Allocation of ADSP and AGUB among target assets.

* * * * *

(c) * * *

(5) *Allocation to certain nuclear decommissioning funds*—(i) *General rule*. For purposes of allocating ADSP or AGUB among the acquisition date assets of a target (and for no other purpose), a taxpayer may elect to treat a nonqualified nuclear decommissioning fund (as defined in paragraph (c)(5)(ii) of this section) of the target as if—

(A) Such fund were an entity classified as a corporation;

(B) The stock of the corporation were among the acquisition date assets of the target and a Class V asset;

(C) The corporation owned the assets of the fund;

(D) The corporation bore the responsibility for decommissioning one or more nuclear power plants to the extent assets of the fund are expected to be used for that purpose; and

(E) A section 338(h)(10) election were made for the corporation (regardless of whether the requirements for a section 338(h)(10) election are otherwise satisfied).

(ii) *Definition of nonqualified nuclear decommissioning fund.* A *nonqualified nuclear decommissioning fund* means a trust, escrow account, Government fund or other type of agreement—

(A) That is established in writing by the owner or licensee of a nuclear generating unit for the exclusive purpose of funding the decommissioning of one or more nuclear power plants;

(B) That is described to the Nuclear Regulatory Commission in a report described in 10 CFR 50.75(b) as providing assurance that funds will be available for decommissioning;

(C) That is not a Nuclear Decommissioning Reserve Fund, as described in section 468A;

(D) That is maintained at all times in the United States; and

(E) The assets of which are to be used only as permitted by 10 CFR 50.82(a)(8).

(iii) *Availability of election*. P may make the election described in this paragraph (c)(5) regardless of whether the selling consolidated group (or the selling affiliate or the S corporation shareholders) also makes the election. In addition, the selling consolidated group (or the selling affiliate or the S corporation shareholders) may make the election regardless of whether P also makes the election. If T is an S corporation, all of the S corporation shareholders, including those that do not sell their stock, must consent to the election for the election to be effective as to any S corporation shareholder.

(iv) *Time and manner of making election*. The election described in this paragraph (c)(5) is made by taking a position on an original or amended tax return for the taxable year of the qualified stock purchase that is consistent with having made the election. Such tax return must be filed no later than the later of 30 days after the date on which the section 338 election is due or the day the original tax return for the taxable year of the qualified stock purchase is due (with extensions).

(v) *Irrevocability of election*. An election made pursuant to this paragraph (c)(5) is irrevocable.

(vi) *Effective/applicability date*. This paragraph (c)(5) applies to qualified stock purchases occurring on or after September 11, 2007. For qualified stock purchases occurring before September 11, 2007 and on or after September 15, 2004, see §1.338–6T as contained in 26 CFR Part 1 in effect on April 1, 2007. For qualified stock purchases occurring before September 15, 2004, see §1.338–6 as contained in 26 CFR Part 1 in effect on April 1, 2004.

§1.338–6T [Removed]

Par. 4. Section 1.338–6T is removed.

Par. 5. Section 1.1060–1 is amended by:

1. Revising in the *Outline of Topics* in paragraph (a)(3), the entry for paragraph (e)(1)(ii)(C).

2. Removing the last sentence of paragraph (c)(3) and adding four new sentences in its place.

3. Revising paragraph (e)(1)(ii)(C).

The revisions read as follows:

§1.1060–1 Special allocation rules for certain asset acquisitions.

(a) * * *

(3) * * *

* * * * *

(e) * * *

(1) * * *

(ii) * * *

(C) Election described in §1.338–6(c)(5).

* * * * *

(c) * * *

(3) *Certain costs.* * * * If an election described in §1.338–6(c)(5) is made with respect to an applicable asset acquisition, any allocation of costs pursuant to this paragraph (c)(3) shall be made as if such election had not been made. The preceding sentence applies to applicable asset acquisitions occurring on or after September 11, 2007. For applicable asset acquisitions occurring before September 11, 2007 and on or after September 15, 2004, see §1.1060–1T as contained in 26 CFR Part 1 in effect on April 1, 2007. For applicable asset acquisitions occurring before September 15, 2004, see §§1.338–6 and 1.1060–1 as contained in 26 CFR Part 1 in effect on April 1, 2004.

* * * * *

(e) * * *

(1) * * *

(ii) * * *

(C) *Election described in §1.338–6(c)(5)—(1) Availability*. The election described in §1.338–6(c)(5) is available in respect of an applicable asset acquisition provided that the requirements of that section are satisfied. Such election may be made by the seller, regardless of whether the purchaser also makes the election, and may be made by the purchaser, regardless of whether the seller also makes the election.

(*2*) *Time and manner of making election*. The election described in §1.338–6(c)(5) is made by taking a position on a timely filed original tax return for the taxable year of the applicable asset acquisition that is consistent with having made the election.

(*3*) *Irrevocability of election*. The election described in §1.338–6(c)(5) is irrevocable.

(*4*) *Effective/applicability date*. This paragraph (e)(1)(ii)(C) applies to applica-

ble asset acquisitions occurring on or after September 11, 2007. For applicable asset acquisitions occurring before September 11, 2007 and on or after September 15, 2004, see §1.1060–1T as contained in 26 CFR Part 1 in effect on April 1, 2007. For applicable asset acquisitions occurring before September 15, 2004, see §§1.338–6 and 1.1060–1 as contained in 26 CFR Part 1 in effect on April 1, 2004.

* * * * *

§1.1060–1T [Removed]

Par. 6. Section 1.1060–1T is removed.

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

Approved August 31, 2007.

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

(Filed by the Office of the Federal Register on September 10, 2007, 8:45 a.m., and published in the issue of the Federal Register for September 11, 2007, 72 F.R. 51703)

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 853.—Foreign Tax Credit Allowed to Shareholders

26 CFR 1.853–1: Foreign tax credit allowed to shareholders.

T.D. 9357

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

Elimination of Country-by-Country Reporting to Shareholders of Foreign Taxes Paid by Regulated Investment Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that generally eliminate country-by-country reporting by a regulated investment company (RIC) to its shareholders of foreign source income that the RIC takes into account and foreign taxes that it pays. This change is necessary to conform the regulations to changes in the tax law relating to the foreign tax credit. These final regulations will affect certain RICs that pay foreign taxes and the shareholders of those RICs.

DATES: *Effective Date:* These regulations are effective on August 24, 2007.

Applicability Date: These regulations are applicable for RIC taxable years ending on or after December 31, 2007. For reporting purposes, however, a taxpayer may rely on the current regulations for a taxable year ending on or after December 31, 2007, and beginning before August 24, 2007.

FOR FURTHER INFORMATION CONTACT: Richard C. LaFalce, (202) 622–3930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been

reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–2035. Comments on the accuracy of the estimated burden and suggestions for reducing the burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224.

The collection of information in these final regulations is in §1.853–4(c) and (d). A RIC is required to notify the IRS of amounts of income received from sources within foreign countries and possessions of the United States and taxes paid to each such foreign country or possession in order that the IRS may monitor shareholder compliance with the foreign tax credit provisions. The collection of information is required if a RIC elects to pass through the benefits of the foreign tax credit to its shareholders.

Estimated total annual recordkeeping burden: 80 hours.

Estimated average annual burden per recordkeeper: 2 hours.

Estimated number of recordkeepers: 40.

Estimated frequency of recordkeeping: Annually.

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

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

Background

This document contains amendments to 26 CFR part 1 under section 853 of the Internal Revenue Code (Code). On September 18, 2006, a notice of proposed rulemaking (REG–105248–04, 2006–43 I.R.B. 787) was published in the **Federal Register** (71 FR 54598). Comments were specifically requested with respect to the effective date of the final regulations. In response, a trade association sent a letter requesting that RICs be allowed to rely on the proposed regulations for 2006. This request was not granted. No public hearing was requested or held.

The proposed regulations are adopted by this Treasury decision with minor modifications. The applicability date for these regulations as adopted, balances the industry's desire promptly to eliminate unneeded RIC reporting with the IRS's need for time in which to update its forms and instructions, thereby reducing potential taxpayer confusion that may arise from the new reporting requirements.

Section 853 provides a foreign tax credit or deduction to shareholders of a RIC that makes an election under, and that meets the requirements set forth in, that section. A RIC more than 50 percent of the value of whose total assets at the close of a taxable year consists of stock or securities in foreign corporations may make an election under section 853 (a "foreign tax passthrough election"). If the RIC makes this election for that taxable year, it forgoes a deduction or credit for certain taxes paid to foreign countries and possessions of the United States (collectively, "foreign taxes") (but the amount of the foreign taxes is allowed as an addition to the RIC's deduction for dividends paid for the year). Instead, the RIC passes through to its shareholders a credit or deduction for the foreign taxes it has paid during its taxable year. If the RIC makes this election, each shareholder includes the shareholder's proportionate share of these foreign taxes in gross income and treats this proportionate share as paid by the shareholder. Each shareholder of an electing RIC further treats as gross income from sources within foreign countries and possessions of the United States the sum of the shareholder's proportionate share of these taxes and the portion of any dividend paid by the RIC that represents income derived from sources within foreign countries and possessions of the United States. Each shareholder may then deduct, or claim a credit for the payment of, a proportionate share of these taxes.

A RIC electing this treatment must provide information to its shareholders and to the IRS. First, under section 853(c) of the Code, the RIC must designate, in a written notice mailed to shareholders not later than 60 days after the close of its taxable year, each shareholder's proportionate share of foreign taxes paid by the RIC and each shareholder's proportionate share of the RIC's gross income derived from sources within any foreign country or possession of the United States. Section 1.853–3(a) of the current Income Tax Regulations requires that this notice designate the shareholder's portion of foreign taxes paid to each such foreign country or possession of the United States and the portion of the dividend that represents income derived from sources within each foreign country or possession of the United States.

Second, under current §1.853–4(a), the RIC must file with Form 1099–DIV, "*Dividends and Distributions*," and Form 1096, "*Annual Summary and Transmittal of U.S. Information Returns*," a statement as part of its income tax return (Form 1120–RIC or its successor) that sets forth the total amount of income received from sources within foreign countries and possessions of the United States; the total amount of foreign taxes paid; the date, form, and contents of the notice to its shareholders; and the proportionate share of this income received and these taxes paid during the taxable year attributable to one share of its stock. The RIC must also file as part of its return for the taxable year a Form 1118, "*Foreign Tax Credit—Corporations*," that has been modified so that it is a statement in support of the RIC's foreign tax passthrough election.

The requirement of current §1.853–3(a) that an electing RIC provide country-by-country information to its shareholders on foreign-source income received and foreign taxes paid was adopted at a time when many shareholders generally needed the information to apply a per-country limitation on the foreign tax credit. Because of changes to the foreign tax credit provisions of the Code, shareholders generally no longer need country-by-country information on the amounts of foreign-source income and foreign taxes paid.

The Treasury Department and the IRS have received comments suggesting that the section 853 regulations should be amended to eliminate per-country reporting to shareholders and that Form 1116, "*Foreign Tax Credit (Individual, Estate or Trust)*," should be modified to indicate that distributions from RICs are exempt from per-country shareholder reporting. According to these comments, eliminating the reporting of this information not only would reduce the time and expense required of RICs to compile and disseminate

this tax information but also would reduce the confusion that their shareholders experience upon receipt of the extensive tables used to report this per-country information.

Even though the section 904 foreign tax credit limitation has been applied on a separate-category-of-income basis, instead of on a per-country basis, since 1976, the Treasury Department and the IRS have continued to require the reporting of per-country information by RICs. This per-country information remains relevant to the IRS's monitoring compliance with the section 901 rules that disallow credits for refundable and noncompulsory payments and for taxes paid to certain countries. See §1.901–2(e)(2) and (5), providing that credit is not allowed for amounts that are in excess of final liability under foreign law for tax, and section 901(j), denying credit for tax paid to countries described in section 901(j)(2)(A) and subjecting income from sources in those countries to separate foreign tax credit limitations.

Although per-country information with respect to foreign income and foreign taxes is needed for the IRS to monitor compliance, the Treasury Department and the IRS believe that taxpayer burden can be reduced by continuing to require this information to be supplied with the RIC's tax return but generally not requiring it to be reported to the RIC's shareholders as well. Accordingly, the final regulations revise §1.853–3 and §1.853–4 to require that a RIC provide aggregate per-country information on a statement filed with its tax return and require that only summary foreign income and foreign tax amounts be reported to its shareholders. The instructions to Forms 1116 and 1118 will be modified to permit summary reporting at the shareholder level similar to the summary reporting currently permitted with respect to "section 863(b) income" on Forms 1116 and 1118.

Explanation of Provisions

The final regulations update §1.853–1 to reflect statutory amendments providing that the foreign tax passthrough election is not applicable to taxes for which the RIC would not be allowed a credit by reason of section 901(j) (denying credit for taxes paid to certain countries, including those with which the United States does not have diplomatic relations), section 901(k) and (*l*) (denying credit for withholding taxes paid on certain income where certain holding period requirements are not met), or any similar provision.

The final regulations change in two ways the regulations that set forth requirements for a RIC seeking to make and to notify shareholders of a foreign tax passthrough election:

First, references in §1.853–3(a) and (b) to required statements to shareholders of dollar amounts of taxes paid to specific countries, and to dollar amounts of income considered as received from specific countries, are changed to require that a RIC (or a shareholder of record of the RIC who is a nominee acting as a custodian of a unit investment trust) state only the total amount of the RIC's shareholder's (or the record shareholder nominee's principal's) proportionate share of creditable foreign taxes paid, income from sources within countries described in section 901(j), if any, and income derived from sources within other foreign countries or possessions of the United States.

Second, the final regulations extend various deadlines in §1.853–3(b) to reflect statutory changes since the regulations were issued. Thus the number of days following the close of its taxable year by which a RIC must notify its shareholders in writing of the making of a foreign tax passthrough election is increased to 60. References to the number of days following the close of the taxable year by which a nominee acting as a custodian of a unit investment trust must notify holders of interests in the unit investment trust is increased to 70. Similarly, references to the number of days following the close of a RIC's taxable year by which a statement that holders of interests in unit investment trusts have been directly notified by the RIC (or a statement that the RIC has failed or is unable to notify these holders of interests) must be filed with the IRS and transmitted to a nominee is increased to 60.

Section 1.853–4 is modified to create more flexibility in the references to specific forms. The current regulations require a RIC to file statements with Form 1099 and Form 1096 and to file, as a part of its return for the taxable year, a Form 1118, modified so that it becomes a statement in support of the election made by a RIC to pass through taxes paid to a foreign country or a possession of the United States. The first of these requirements, the requirement to file statements with Forms 1099 and 1096, is eliminated. The final regulations retain the general requirement that a RIC must file as part of its return a statement that elects the application of section 853 for the taxable year.

Section 1.853–4(a) also requires that a RIC agree to provide certain information on foreign-source income received and foreign taxes paid. The information required to be provided is set forth in §1.853–4(c). Section 1.853–4(d) continues to provide that this required information is to be provided on or with a modified Form 1118 but adds that it may instead be provided in such other form or manner as may be prescribed by the Commissioner. This change facilitates future changes in administrative practice if, for example, forms are renumbered or become obsolete.

Special Analyses

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

Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. §605(b), it has also been determined that the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to these regulations because these regulations do not have a significant economic impact on a substantial number of small entities. According to the Small Business Administration definition of a "small business," 13 C.F.R. 121.201, a RIC is classified as a Portfolio Management company, NAICS code 523920, and is considered a small entity if it accumulates less than 6.5 million dollars in annual receipts. It has been determined that RICs affected by these regulations generally will have greater than 6.5 million dollars in annual receipts and therefore will not generally be classified as small business entities.

Because the summary reporting of the foreign tax credit information provided by these regulations is universally less burdensome than the reporting of country-by-country information previously required, it is also clear that these regulations do not have a significant economic impact on affected RICs. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of this regulation is Richard C. LaFalce of the Office of Associate Chief Counsel (Financial Institutions and Products).

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.853–1 also issued under 26 U.S.C. 901(j).

Section 1.853–2 also issued under 26 U.S.C. 901(j).

Section 1.853–3 also issued under 26 U.S.C. 901(j).

Section 1.853–4 also issued under 26 U.S.C. 901(j) and 26 U.S.C. 6011. * * *

Par. 2. Section 1.853–1 is amended by adding a sentence at the end of paragraph (a) and adding paragraph (c) to read as follows:

§1.853–1 Foreign tax credit allowed to shareholders.

(a) *In general*. * * * In addition, the election is not applicable to any tax with respect to which the regulated investment company is not allowed a credit by reason of any provision of the Internal Revenue Code other than section 853(b)(1), including, but not limited to, section 901(j), section 901(k), or section 901(*l*).

* * * * *

(c) *Effective/applicability date*. The final sentence of paragraph (a) of this section is applicable for RIC taxable years ending on or after December 31, 2007.

Par. 3. Section 1.853–2 is amended by revising paragraph (d) and adding paragraph (e) to read as follows:

§1.853–2 Effect of election.

* * * * *

(d) *Example*. This section is illustrated by the following example:

Example. (i) *Facts*. X Corporation, a regulated investment company with 250,000 shares of common stock outstanding, has total assets, at the close of the taxable year, of $10 million ($4 million invested in domestic corporations, $3.5 million in Foreign Country A corporations, and $2.5 million in Foreign Country B corporations). X Corporation received dividend income of $800,000 from the following sources: $300,000 from domestic corporations, $250,000 from Country A corporations, and $250,000 from Country B corporations. All dividends from Country A corporations and from Country B corporations were properly characterized as income from sources without the United States. The dividends from Country A corporations were subject to a 10 percent withholding tax ($25,000) and the dividends from Country B corporations were subject to a 20 percent withholding tax ($50,000). X Corporation's only expenses for the taxable year were $80,000 of operation and management expenses related to both its U.S. and foreign investments. In this case, Corporation X properly apportioned the $80,000 expense based on the relative amounts of its U.S. and foreign source gross income. Thus, $50,000 in expense was apportioned to foreign source income ($80,000 × $500,000/$800,000, total expense times the fraction of foreign dividend income over total dividend income) and $30,000 in expense was apportioned to U.S. source income ($80,000 × $300,000/$800,000, total expense times the fraction of U.S. source dividend income over total dividend income). During the taxable year, X Corporation distributed to its shareholders the entire $645,000 income that was available for distribution ($800,000, less $80,000 in expenses, less $75,000 in foreign taxes withheld).

(ii) *Section 853 election*. X Corporation meets the requirements of section 851 to be considered a RIC for the taxable year and the requirements of section 852(a) for part 1 of subchapter M to apply for the taxable year. X Corporation notifies each shareholder by mail, within the time prescribed by section 853(c), that by reason of the election the shareholders are to treat as foreign taxes paid $0.30 per share of stock ($75,000 of foreign taxes paid, divided by the 250,000 shares of stock outstanding). The shareholders must report as income $2.88 per share ($2.58 of dividends actually received plus the $0.30 representing foreign taxes paid). Of the $2.88 per share, $1.80 per share ($450,000 of foreign source taxable income divided by 250,000 shares) is to be considered as received from foreign sources. The $1.80 consists of $0.30, the foreign taxes treated as paid by the shareholder and $1.50, the portion of the dividends received by the shareholder from the RIC that represents income of the RIC treated as derived from foreign sources ($500,000 of foreign source income, less $50,000 of expense apportioned to foreign source income, less $75,000 of foreign tax withheld, which is $375,000, divided by 250,000 shares).

(e) *Effective/applicability date*. Paragraph (d) of this section is applicable for RIC taxable years ending on or after December 31, 2007. Notwithstanding the preceding sentence, for a taxable year that ends on or after December 31, 2007, and begins before August 24, 2007, a taxpayer may rely on this section as it was in effect on August 23, 2007.

Par. 4. Section 1.853–3 is amended by:

1. Revising paragraph (a).

2. Removing the number "55th" and adding the number "70th" in its place in the first sentence of paragraph (b).

3. Revising the second sentence of paragraph (b).

4. Removing the number "45" and adding the number "60" in its place in each place in which it appears in the fifth sentence of paragraph (b).

5. Adding paragraph (c).

The revisions and addition read as follows:

§1.853–3 Notice to shareholders.

(a) *General rule*. If a regulated investment company makes an election under section 853(a), in the manner provided in §1.853–4, the regulated investment company is required under section 853(c) to furnish its shareholders with a written notice mailed not later than 60 days after the close of its taxable year. The notice must designate the shareholder's portion of creditable foreign taxes paid to foreign countries or possessions of the United States and the portion of the dividend that represents income derived from sources within each country that is attributable to a period during which section 901(j) applies to such country, if any, and the portion of the dividend that represents income derived from other foreign countries and possessions of the United States. For purposes of section 853(b)(2) and §1.853–2(b), the amount that a shareholder may treat as the shareholder's proportionate share of foreign taxes paid and the amount to be included as gross income derived from any foreign country that is attributable to a period during

which section 901(j) applies to such country or gross income from sources within other foreign countries or possessions of the United States shall not exceed the amount so designated by the regulated investment company in such written notice. If, however, the amount designated by the regulated investment company in the notice exceeds the shareholder's proper proportionate share of foreign taxes or gross income from sources within foreign countries or possessions of the United States, the shareholder is limited to the amount correctly ascertained.

(b) * * * The notice shall designate the holder's proportionate share of the amounts of creditable foreign taxes paid to foreign countries or possessions of the United States and the holder's proportionate share of the dividend that represents income derived from sources within each country that is attributable to a period during which section 901(j) applies to such country, if any, and the holder's proportionate share of the dividend that represents income derived from other foreign countries or possessions of the United States shown on the notice received by the nominee pursuant to paragraph (a) of this section. * * *

(c) *Effective/applicability date*. This section is applicable for RIC taxable years ending on or after December 31, 2007. Notwithstanding the preceding sentence, for a taxable year that ends on or after December 31, 2007, and begins before August 24, 2007, a taxpayer may rely on this section as it was in effect on August 23, 2007.

Par. 5. Section 1.853–4 is revised to read as follows:

§1.853–4 Manner of making election.

(a) *General rule*. To make an election under section 853 for a taxable year, a regulated investment company must file a statement of election as part of its Federal income tax return for the taxable year. The statement of election must state that the regulated investment company elects the application of section 853 for the taxable year and agrees to provide the information required by paragraph (c) of this section.

(b) *Irrevocability of the election*. The election shall be made with respect to all foreign taxes described in paragraph (c)(2) of this section, and must be made not later than the time prescribed for filing the return (including extensions). This election, if made, shall be irrevocable with respect to the dividend (or portion thereof), and the foreign taxes paid with respect thereto, to which the election applies.

(c) *Required information*. A regulated investment company making an election under section 853 must provide the following information:

(1) The total amount of taxable income received in the taxable year from sources within foreign countries and possessions of the United States and the amount of taxable income received in the taxable year from sources within each such foreign country or possession.

(2) The total amount of income, war profits, or excess profits taxes (described in section 901(b)(1)) to which the election applies that were paid in the taxable year to such foreign countries or possessions and the amount of such taxes paid to each such foreign country or possession.

(3) The amount of income, war profits, or excess profits taxes paid during the taxable year to which the election does not apply by reason of any provision of the Internal Revenue Code other than section 853(b), including, but not limited to, section 901(j), section 901(k), or section 901(l).

(4) The date, form, and contents of the notice to its shareholders.

(5) The proportionate share of creditable foreign taxes paid to each such foreign country or possession during the taxable year and foreign income received from sources within each such foreign country or possession during the taxable year attributable to one share of stock of the regulated investment company.

(d) *Time and manner of providing information*. The information specified in paragraph (c) of this section must be provided at the time and in the manner prescribed by the Commissioner and, unless otherwise prescribed, must be provided on or with a modified Form 1118 "*Foreign Tax Credit—Corporations*" filed as part of the RIC's timely filed Federal income tax return for the taxable year.

(e) *Effective/applicability date*. This section is applicable for RIC taxable years ending on or after December 31, 2007. Notwithstanding the preceding sentence, for a taxable year that ends on or after December 31, 2007, and begins before August 24, 2007, a taxpayer may rely on this section as it was in effect on August 23, 2007.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In §602.101, paragraph (b) is amended by revising the entries for 1.853–3 and 1.853–4 to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified or described	Current OMB control No.
* * * * *	
1.853–3	1545–2035
1.853–4	1545–2035
* * * * *	

Approved August 9, 2007.

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

Karen G. Sowell,
Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on August 23, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 24, 2007, 72 F.R. 48551)

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for October 2007.

Rev. Rul. 2007–63

This revenue ruling provides various prescribed rates for federal income tax purposes for October 2007 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2007–63 TABLE 1

Applicable Federal Rates (AFR) for October 2007

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term				
AFR	4.19%	4.15%	4.13%	4.11%
110% AFR	4.62%	4.57%	4.54%	4.53%
120% AFR	5.04%	4.98%	4.95%	4.93%
130% AFR	5.47%	5.40%	5.36%	5.34%
Mid-term				
AFR	4.35%	4.30%	4.28%	4.26%
110% AFR	4.79%	4.73%	4.70%	4.68%
120% AFR	5.23%	5.16%	5.13%	5.11%
130% AFR	5.67%	5.59%	5.55%	5.53%
150% AFR	6.55%	6.45%	6.40%	6.36%
175% AFR	7.67%	7.53%	7.46%	7.41%
Long-term				
AFR	4.88%	4.82%	4.79%	4.77%
110% AFR	5.37%	5.30%	5.27%	5.24%
120% AFR	5.86%	5.78%	5.74%	5.71%
130% AFR	6.37%	6.27%	6.22%	6.19%

REV. RUL. 2007–63 TABLE 2

Adjusted AFR for October 2007

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.60%	3.57%	3.55%	3.54%
Mid-term adjusted AFR	3.79%	3.75%	3.73%	3.72%
Long-term adjusted AFR	4.49%	4.44%	4.42%	4.40%

REV. RUL. 2007–63 TABLE 3

Rates Under Section 382 for October 2007

Adjusted federal long-term rate for the current month	4.49%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.50%

REV. RUL. 2007–63 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for October 2007

Appropriate percentage for the 70% present value low-income housing credit	8.07%
Appropriate percentage for the 30% present value low-income housing credit	3.46%

REV. RUL. 2007–63 TABLE 5

Rate Under Section 7520 for October 2007

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.2%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2007. See Rev. Rul. 2007-63, page 778.

Part III. Administrative, Procedural, and Miscellaneous

2008 Transition Relief and Additional Guidance on the Application of § 409A to Nonqualified Deferred Compensation Plans

Notice 2007–78

I. PURPOSE

This notice provides transition relief and additional guidance on the application of § 409A of the Internal Revenue Code to nonqualified deferred compensation plans. This transition relief and additional guidance includes:

- Extension to December 31, 2008, of the deadline to adopt documents that comply with § 409A, subject to limited requirements regarding the timely written designation of a time and form of payment.
- Guidance and additional relief addressing certain issues raised by the application to employment agreements and cashout features of § 409A and the final regulations.
- Announcement that the Treasury Department and the IRS anticipate issuing guidance containing a limited voluntary compliance program that will permit taxpayers to correct certain unintentional operational violations of § 409A and thereby limit the amount of additional taxes due under § 409A.
- Announcement that the relief from the application of § 409A(b) (which prohibits the use of certain types of arrangements to pay for nonqualified deferred compensation) provided in Notice 2006–33, 2006–1 C.B. 754, with respect to certain "grace period assets", which expires December 31, 2007, is not being extended, so that after December 31, 2007, taxpayers must comply with a reasonable, good faith interpretation of § 409A(b) with respect to all assets in arrangements subject to § 409A(b).

II. BACKGROUND

Section 409A provides certain requirements applicable to nonqualified deferred compensation plans. If a plan does not meet those requirements, participants in the plan are required to immediately include amounts deferred under the plan in income and pay additional taxes on such income.

The Treasury Department and the IRS issued final regulations under § 409A in April 2007 (T.D. 9321, 2007–19 I.R.B. 1123 [72 Fed. Reg. 19234] (April 17, 2007)). The final regulations apply to taxable years beginning on or after January 1, 2008. In general, the final regulations require that the material terms of a nonqualified deferred compensation plan be in writing. See § 1.409A–1(c). Commentators stated that taxpayers anticipate difficulties in formally amending existing plans to comply with the final regulations by the January 1, 2008 deadline. In addition, a number of commentators have raised questions regarding the application of the final regulations to certain types of plans. This notice is issued in response to these comments and questions.

III. 2008 TRANSITION RELIEF

A. In General

Section 409A generally applies to amounts deferred under a nonqualified deferred compensation plan to the extent the amounts deferred under the plan were not earned and vested before January 1, 2005. The final regulations are applicable for taxable years beginning on or after January 1, 2008, and a nonqualified deferred compensation plan must meet the requirements set forth in the final regulations as of the first day of the taxable year. This section provides certain limited transition relief, until December 31, 2008, with respect to the plan document requirements. The transition relief in this notice is not an extension of any of the transition relief provided in Notice 2005–1, 2005–1 C.B. 274, the preamble to the proposed regulations under § 409A, 70 Fed. Reg. 57930 (REG–158080–04, 2005–2 C.B. 786) (Oct. 4, 2005), or Notice 2006–79, 2006–43 I.R.B. 763. Accordingly, except where otherwise provided in the section of the preamble to the final regulations entitled "Effect on Other Documents," taxpayers may not rely upon Notice 2005–1, the proposed regulations, or a reasonable, good faith interpretation of the statute for taxable years beginning on or after January 1, 2008. In addition, after December 31, 2007, taxpayers may not change the time and form of payment except as permitted under the final regulations and this notice, and no change in the time and form of payment after December 31, 2007, may result in an amount that was deferred as of December 31, 2007, qualifying for an exclusion from the definition of deferred compensation under the final regulations. See § 1.409A–1(a)(1).

B. Retroactive Amendment Period

The written provisions of a plan may fail to meet the requirements of § 409A, the final regulations, and any other applicable guidance, because the plan includes a provision that causes the plan to fail to satisfy the requirements of § 409A, or because the plan fails to include a written provision that is required to satisfy the requirements of § 409A. (For purpose of this notice, § 409A, the final regulations, and any other guidance applicable to a plan or a deferred amount is referred to collectively as "the § 409A guidance".) However, under the transition relief provided in this notice, except as otherwise provided in section III.C of this notice addressing the designation of the time and form of payment of deferred amounts, a nonqualified deferred compensation plan will not violate the requirements of § 409A on or before December 31, 2008 merely because the written provisions of the plan fail to meet the requirements of the § 409A guidance, provided that the plan is operated in accordance with the requirements of the § 409A guidance and is amended on or before December 31, 2008 to comply with the § 409A guidance retroactively to January 1, 2008.

A plan is treated as having been amended to comply with the § 409A guidance retroactively to January 1, 2008, only if the written plan, as amended, contains all of the written provisions required by the final regulations and accurately reflects the operation of the plan on and after January 1, 2008, through the date of the amendment, including the terms and conditions under which any initial deferral elections or subsequent deferral elections

were permitted, and how the operation of such plan met the requirements of the § 409A guidance on and after January 1, 2008, through the date of the amendment. For additional guidance related to the adoption of new plans, or the adoption of an amendment to an existing plan increasing amounts deferred under the plan, see § 1.409A–1(c)(3)(i) and (vi).

C. Transition Relief — Designation of a Compliant Time and Form of Payment

This section provides guidelines under which, for periods on or before December 31, 2008, a nonqualified deferred compensation plan will be treated as meeting the requirement to timely designate a time and form of payment of an amount deferred under the plan. Nothing in this section alters the requirement that the plan be operated in accordance with the requirements of the § 409A guidance (including this notice) on and after January 1, 2008, and be amended on or before December 31, 2008, to comply with § 409A and the applicable guidance retroactively to January 1, 2008. For example, nothing in this notice alters the taxpayer's burden to demonstrate that any initial deferral election or subsequent deferral election was made in a manner that complied in operation with the § 409A guidance. In addition, nothing in this section alters the restrictions on changes in the time and form of payment on or before December 31, 2007 under the transition rules set forth in Notice 2005–1, the preamble to the proposed regulations, Notice 2006–79, and the preamble to the final regulations.

1. How to Designate the Time and Form of Payment

Unless a later date is permitted under the final regulations, if there have been deferrals of compensation under a plan as of January 1, 2008, but the deferred compensation has not been paid, the plan will not comply with § 409A after December 31, 2007, unless the plan designates in writing before January 1, 2008, a compliant time and form of payment of such deferred compensation. Amounts deferred after December 31, 2007, and before January 1, 2009, will not comply with § 409A unless the plan designates in writing a compliant time and form of payment of such amounts on or before the applicable deadline under the final regulations (See § 1.409A–2(a) for the rules governing initial deferral elections). For purposes of this section, a plan will designate a compliant time and form of payment of an amount if the written plan terms, disregarding any written plan provisions that do not comply with the § 409A guidance (including this section), provide a compliant time and form of payment as described in section III.C.2 of this notice. For example, if a plan provides for a payment upon a separation from service, but permits the service provider to elect an immediate lump sum payment subject to a forfeiture of a specified portion of the deferred amount (a haircut provision), the haircut provision may be disregarded and the plan will be treated as providing for a payment upon a separation from service, provided the haircut provision is not utilized, and that the haircut provision is removed and the time and form of payment is otherwise fully compliant with the regulations by December 31, 2008. Also, for purposes of this section, a separate written document may be adopted that provides a time and form of payment for amounts deferred under arrangements that are specifically identified (for example, amounts deferred under the Company X Salary Deferral Plan), or that provides a time and form of payment for amounts deferred under arrangements that are not specifically identified (for example, amounts deferred under any arrangement with the service recipient providing the service provider deferred compensation subject to § 409A), or a combination (for example specifying a time and form of payment for amounts deferred under the Company X Salary Deferral Plan, and another time and form of payment for amounts deferred under all other arrangements with the service recipient providing the service provider deferred compensation subject to § 409A), provided that the deferred amounts to which each designated time and form of payment applies are objectively determinable.

2. How to Designate a Compliant Time and Form of Payment

For purposes of this section III.C, a plan will only provide for a compliant time and form of payment for a deferred amount if the plan provides for an objectively determinable form of payment payable upon:

(1) A separation from service;

(2) A change in control event;

(3) An unforeseeable emergency;

(4) A specified date or fixed schedule of payments;

(5) Death; or

(6) Disability.

For example, a plan may provide that an amount deferred under the plan will be paid in the form of a life annuity commencing on the later of the service provider's separation from service or attaining age 65. However, a plan may not provide that an amount deferred under the plan will be paid during the three years following the service provider's separation from service (with the exact timing of the payment during the three-year period determined at the discretion of the service recipient), because that plan term would not provide a compliant time and form of payment. Similarly, a stock option that is subject to § 409A could not provide the service provider the discretion to exercise the stock option over more than one taxable year, because that plan term would not provide a compliant time of payment. See § 1.409A–3(c) for rules on when a plan may designate alternative specified dates or payment schedules with respect to particular payment events.

If the objectively determinable form of payment is a series of installment payments, as defined in § 1.409A–2(b)(2)(iii), the series of installment payments is treated as a single payment unless the plan designates in writing on or before the deadline by which the time and form of payment must be set forth in writing under section III.C.1 of this notice (the section III.C.1 deadline), that the series of installment payments is to be treated as a right to a series of separate payments. On and after the section III.C.1 deadline, the treatment of a series of installment payments as a single payment or as a series of separate payments may not be modified except as permitted under the final regulations.

The plan may specify any combination of payment events that is permissible under the final regulations, including that a deferred amount is to be paid upon the earliest of these events or the latest of these events. However, if a payment event is not specified in writing as a potential payment event on or before the section III.C.1 deadline, the addition of that payment event as a potential payment event is subject to the anti-acceleration provisions under

§ 1.409A–3(j) and the subsequent deferral election provisions under § 1.409A–2(b). For example, a plan providing for the payment of an amount upon the earliest of a service provider's death, disability, or separation from service would provide for a compliant time and form of payment. However, the modification of the provision after the section III.C.1 deadline to provide for the payment of the amount upon the earliest of a service provider's death, disability, or separation from service, or a change in control event, would be an impermissible acceleration of the payment. Similarly, if a payment event is specified in writing on the section III.C.1 deadline as a potential payment event, the removal of the payment event after the applicable deadline as a potential payment event is subject to the anti-acceleration provisions under § 1.409A–3(j) and the subsequent deferral election provisions under § 1.409A–2(b).

3. Retroactive Adoption of Permissible Payment Event Definitions

For purposes of this section, *separation from service* means any event that may qualify as a separation from service under § 1.409A–1(h), *change in control event* means any event that may qualify as a change in control event under § 1.409A–3(i)(5), *unforeseeable emergency* means any event that may qualify as an unforeseeable emergency under § 1.409A–3(i)(3), and *disability* means any event that may qualify as a disability under § 1.409A–3(i)(4). For example, a plan providing only that a payment will be made upon a separation from service (or similar term such as termination of employment) may be treated as providing for a payment upon a separation from service as defined in § 1.409A–1(h). However, the plan must be operated in accordance with the final regulations, so that a payment due upon the service provider's separation from service could only be made upon an event that met the requirements of the definition of separation from service set forth in §1.409A–1(h), and the plan must be amended by December 31, 2008 to accurately reflect the application of the provisions during 2008 and to fully comply with the requirements of the final regulations. Similarly, a plan providing that a payment will be made upon the service provider's disability may be treated as providing for a payment upon a disability as defined in § 1.409A–3(i)(4). However, the plan must be operated in accordance with the final regulations, so that a payment due upon the service provider's disability could only be made upon a disability that met the requirements of the definition of disability set forth in § 1.409A–3(i)(4), and the plan must be amended by December 31, 2008 to accurately reflect the application of the provision during 2008 and to fully comply with the requirements of the final regulations.

For a deferred amount, a plan will not be treated as failing to meet the requirements of § 409A and the final regulations merely because the plan fails to specify in writing the definition of a payment event that is a separation from service, a change in control event, disability, or unforeseeable emergency, applied under the plan on or before December 31, 2008, provided that the definition applied is permissible under the final regulations and the plan is amended on or before December 31, 2008, to accurately reflect the application of the provision during 2008 and to fully comply with the requirements of the final regulations. For example, § 1.409A–1(h)(1)(ii) provides that whether a termination of employment that is a separation from service has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of *bona fide* services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of *bona fide* services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or the full period of services to the employer if the employee has been providing services to the employer for less than 36 months). Section 1.409A–1(h)(1)(ii) further provides that a plan may treat another level of reasonably anticipated permanent reduction in the level of *bona fide* services as a separation from service, provided that the level of reduction required must be designated in writing as a specific percentage, and the reasonably anticipated reduced level of *bona fide* services must be greater than 20% but less than 50% of the average level of *bona fide* services provided in the immediately preceding 36 months. A plan is not required to set forth in writing as of January 1, 2008 whether this alternative definition has been adopted, and may provide that a payment is to be made upon a separation from service of an employee without designating whether the required reduction in the level of services is 20%, 50%, or some other reduction in the level of services available under the final regulations. However, not later than December 31, 2008, the written terms of the plan, including the designation of the payment date, must be both fully compliant with the final regulations and consistent with the application of such designated payment event on and after January 1, 2008.

If a payment event that is a separation from service, a change in control event, an unforeseeable emergency, or a disability, has been timely designated, a later adoption of an alternative definition of the designated payment event, as applicable (or if an alternative definition has been adopted, an adoption of the default definition or another alternative definition), on or before December 31, 2008, will not be treated as a change in the time or form of payment, regardless of whether the adoption of the alternative definition would result in a payment being made at an earlier or later date than under the default definition or the previously designated definition (for example, an alternative definition is adopted during 2007, and a new alternative definition is adopted during 2008). Solely for purposes of effecting the relief provided in this section III.C.3, the availability of a payment to a service provider had the service recipient not been permitted to adopt an alternative definition will not be treated as causing the amount to be includible in income under § 451 or the doctrine of constructive receipt. However, once an event has occurred in 2008 and been treated as a payment event (or as not qualifying as a payment event), the service recipient and service provider may not retroactively alter the definition of the payment event applicable to such deferred amount.

For example, assume that as of December 31, 2007, a plan provided for a deferred amount to be paid as a lump sum payment on or before the 30th day following an employee's separation of service whose level of services for the past 3 years has been 40

hours per week. Assume further that on April 1, 2008, the participating employee (who is not a specified employee) permanently reduces his level of services from 40 hours per week to 10 hours per week. If the amount is paid on or before December 31, 2008, the payment would be consistent with the adoption of a definition of separation from service that is consistent with the requirements of the final regulations for a separation from service, which in this case would be a permanent reduction in the level of services to a level at or below 25% of the level of services previously provided. As of December 31, 2008, the plan would be required to be amended retroactively with respect to that deferred amount to reflect a definition of separation from service consistent with that treatment. In contrast, if the amount is not paid on or before December 31, 2008, the failure to make a payment would be consistent with a definition of separation from service that did not include a reduction in the level of services to a level at or above 25% of the level of services previously provided. As of December 31, 2008, the plan either would be required to apply the default definition of separation from service in the final regulations or would be required to be amended retroactively to reflect a definition of separation from service consistent with that treatment, and any change in the definition of separation from service with respect to such deferred amount after the participating employee's permanent reduction in the level of services on April 1, 2008, would be subject to the anti-acceleration provisions of § 1.409A–3(j) and the subsequent deferral election provisions of § 1.409A–2(b).

4. How to Designate a Specified Payment Date or a Fixed Schedule of Payments

For purposes of section III.C.1, the designation of a specified payment date or a fixed schedule of payments, including the use of a specified payment date or a fixed schedule of payments after a permissible payment event or the lapse of a substantial risk of forfeiture, must meet the requirements of § 1.409A–3(i)(1). Accordingly, the plan must meet the requirements of § 1.409A–3(i)(1) by December 31, 2007, for any amount that will be paid in accordance with:

(1) § 1.409A–3(i)(1)(i) (specified time or fixed schedule in general);

(2) § 1.409A–3(i)(1)(ii) (payment schedules with formula and fixed limitations);

(3) § 1.409A–3(i)(1)(iii) (payment schedules determined by timing of payments received by the service recipient);

(4) § 1.409A–3(i)(1)(iv) (reimbursement or in-kind benefit plans); and

(5) § 1.409A–3(i)(1)(v) (tax gross-up payments)

However, a payment schedule that would otherwise qualify as a fixed schedule of payments under § 1.409A–3(i)(1)(v) (tax gross-up payments), except that the arrangement does not require that the payment be made by the end of the service provider's taxable year next following the service provider's taxable year in which the service provider remits the related taxes, will be treated as designating a fixed schedule of payments if the plan is amended on or before December 31, 2008 to provide for such a requirement, and the plan is operated in compliance with such requirement for periods after December 31, 2007 through the date of the amendment.

In addition, for a specified payment date or a fixed schedule of payments, the addition or deletion of a designated payment provision that meets the requirements of § 1.409A–3(b) or § 1.409A–3(i)(1)(i), as applicable, and does not affect the taxable year in which the payment will be made, is not treated as a change in the time and form of payment if the addition or deletion is made on or before December 31, 2008. For example, if a plan provides for an immediate lump sum payment upon death, the addition of a plan provision on or before December 31, 2008, providing that the payment will be made on or before the end of the service provider's taxable year in which the event occurs will not be treated as a change in the time and form of payment. The addition, deletion or modification of a provision that provides that a payment (including a payment that is part of a schedule) is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs if the designated period is not more than 90 days and the service provider does not have a right to designate the taxable year of the payment (other than an election that complies with the subsequent deferral election rules of § 1.409A–2(b)), also will not be treated as a change in the time and form of payment. For example, if a plan provides that a payment will be made in a lump sum payment upon separation from service, a modification of the plan on or before December 31, 2008, to provide that the payment will be made on or before the 90th day following the separation from service, determined at the sole discretion of the service recipient, is not treated as a change in the time and form of payment. However, plan provisions designating the time and form of payment must be fully compliant with the final regulations as of December 31, 2008.

5. Retroactive Amendments and the Six-Month Delay on Payments to Specified Employees

Section 1.409A–3(i)(2) provides that in the case of any service provider who is a specified employee (as defined in § 1.409A–1(i)) as of the date of a separation from service, the requirements of § 1.409A–1(a)(1) permitting a payment upon a separation from service are satisfied only if payments may not be made before the date that is six months after the date of separation from service (or, if earlier than the end of the six-month period, the date of death of the specified employee). Section 1.409A–1(c)(3)(v) generally requires that the delay requirement be a written provision of any plan providing for a payment upon separation from service to a specified employee. Provided that such payments are delayed in accordance with § 1.409A–1(a)(1), a plan will not be treated as failing to meet the requirements of § 1.409A–1(c)(3)(v) provided that the plan is amended on or before December 31, 2008, retroactively to January 1, 2008, to contain the requirement, and the written plan provision accurately reflects the operation of the plan through the date of the amendment. Taxpayers must demonstrate that the required delay was applied to affected payments. Accordingly, if the service recipient has used any provisions other than the default provisions of § 1.409A–1(i) to identify specified employees, taxpayers must demonstrate the method by which the service recipient identified any specified employees, and that such method of iden-

tifying specified employees was applied consistently to all plans and all service providers.

IV. APPLICATION OF FINAL REGULATIONS AND ADDITIONAL RELIEF

A. Employment Agreements — Good Reason Provisions

Whether a separation from service is involuntary generally is important for the application of the exception from the definition of deferred compensation contained in § 1.409A–1(b)(4) (the short-term deferral rule). Under the short-term deferral rule, an arrangement that provides for a payment within certain limited periods following the lapse of a substantial risk of forfeiture may not constitute deferred compensation. Section 1.409A–1(d) provides that if a service provider's entitlement to an amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.

Whether a separation from service is involuntary is also important for the application of the exclusion for certain separation pay arrangements under § 1.409A–1(b)(9). That provision excludes from deferred compensation a right to certain amounts that are payable within a limited period of time following an involuntary separation from service, and is available only if the amounts are payable upon an involuntary separation from service (often referred to as the "two-year, two-time rule").

Section 1.409A–1(n) provides a definition of an involuntary separation from service. Section 1.409A–1(n)(2)(i) provides that as a general rule a service provider's voluntary separation from service will be treated as an involuntary separation from service if the separation from service occurs under certain limited *bona fide* conditions, where the avoidance of the requirements of § 409A is not a purpose of the inclusion of these conditions in the plan or of the actions by the service recipient in connection with the satisfaction of these conditions, and a voluntary separation from service under such conditions effectively constitutes an involuntary separation from service. Section 1.409A–1(n)(2)(ii) contains a safe harbor setting forth a set of conditions often referred to as the "safe harbor good reason conditions". The safe harbor states that if a plan provides that a voluntary separation from service will be treated as an involuntary separation from service if the separation from service occurs under certain express conditions, a separation from service satisfying the conditions set forth in the plan will be treated as an involuntary separation from service if the necessary conditions (or set of conditions) satisfy the requirements of the regulations.

Commentators have stated that to ensure qualification for one or both of the short-term deferral rule or the two-year, two-time rule, taxpayers have considered modifying employment arrangements that currently provide for a payment upon a voluntary separation from service under certain conditions (often referred to as "good reason conditions"), including modifying the good reason conditions under which an employee could voluntarily terminate employment and receive payments. Some taxpayers want to replace the existing good reason conditions in their agreements with a set of safe harbor good reason conditions qualifying under § 1.409A–1(n)(2)(ii). Other taxpayers want to add only some of the safe harbor good reason conditions (for example, adding a requirement that the employee provide notice to the employer that the good reason condition has been satisfied). Other taxpayers have proposed removing a condition from an existing agreement, because the condition is not a condition found in the good reason safe harbor.

The modification of these arrangements raises issues regarding whether a substantial risk of forfeiture condition has been added or modified in a manner that would not be respected under Notice 2005–1, Q&A–10, proposed § 1.409A–1(d) or final § 1.409A–1(d). Notice 2005–1, Q&A–10 provides that any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. See also proposed and final § 1.409A–1(d).

The Treasury Department and the IRS understand that taxpayers may desire to conform existing good reason conditions to the requirements of the definition of an involuntary separation from service under the regulations. Accordingly, to the extent that a right to a payment subject to an existing good reason condition is subject to a substantial risk of forfeiture, the modification of the good reason condition on or before December 31, 2007 to conform to some or all of the conditions set forth in § 1.409A–1(n)(2) will not be treated as an extension of the substantial risk of forfeiture. However, if the right to a payment subject to existing good reason conditions is not subject to a substantial risk of forfeiture, the modification of such condition to include one or more of the conditions set forth in § 1.409A–1(n)(2)(ii), or to remove one or more of the existing good reason conditions, will not cause the amount to be treated as subject to a substantial risk of forfeiture.

As provided by Notice 2006–79, for amounts subject to § 409A, a plan may provide, or be amended to provide, for new payment elections on or before December 31, 2007, with respect to both the time and form of payment of such amounts and the election or amendment will not be treated as a change in the time or form of payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the plan is so amended and elections are made on or before December 31, 2007. With respect to an election or amendment to change a time and form of payment made on or after January 1, 2007, and on or before December 31, 2007, the election or amendment may apply only to amounts that would not otherwise be payable in 2007 and may not cause an amount to be paid in 2007 that would not otherwise be payable in 2007. An election of a new time and form of payment under these transition rules may cause an amount to be excluded from coverage under § 409A. In the case of a right to a payment of deferred compensation, the modification of the time and form of the payment such that the payment will only be made upon an involuntary separation from service may result in the exclusion of such right, or a portion of such right, from the definition of deferred compensation under § 1.409A–1(b)(9) (the

two-year, two-time rule), to the extent the amended arrangement otherwise met the requirements for the exclusion. In modifying the arrangement, however, taxpayers should ensure that the amendment does not affect amounts that otherwise would be payable in 2007 (for example, because a separation from service occurred during 2007).

B. Employment Agreements — Application of Substitution Rule

Commentators have asked about the conditions under which rights to deferred compensation under an extension of an employment agreement, or a negotiation of a new employment agreement, will constitute a new legally binding right to compensation rather than a substitution for rights to deferred compensation contained under a previous agreement. Until further guidance, if a right to deferred compensation payable only upon an involuntary separation from service (as defined under § 1.409A–1(n)) at all times under an employment agreement would automatically be forfeited at the end of the term of the employment agreement, then the grant of a right to deferred compensation in an extended, renewed or renegotiated employment agreement will not be treated as a substitute for the right that was forfeited at the termination of the prior employment agreement. For example, if an employment agreement at all times provides that an employee has a right to deferred compensation if the employee is involuntarily separated from service without cause during the three-year term of the employment agreement, but that deferred compensation will become payable at the end of the original three-year term of the employment agreement if the employee is available to perform services and the employer does not extend, renew, or replace the employment agreement, and at the end of the three-year term of the employment agreement the employee has not been involuntarily separated, the right to deferred compensation in a renewed, extended or renegotiated employment agreement may be viewed as a substitute for the right to deferred compensation in the original agreement. However, if the employment agreement had not provided that any deferred compensation would become payable at the end of the original three-year term of the employment agreement if the employee had been available to perform services and the employer had not extended, renewed or replaced the employment agreement, and the employee had not been involuntarily separated during the three-year term of the employment agreement, then a right to deferred compensation under an employment agreement covering services after the end of the original three-year term would not be treated as a substitute for the right to the deferred compensation upon an involuntary separation from service during the original three-year term.

C. Predetermined Cashouts

Section 1.409A–2(b)(2)(iii) provides a limited ability to provide for the cashout of all remaining installments under an installment payment provision when the present value of the remaining payments falls below the predetermined threshold. Section 1.409A–2(b)(2)(ii) provides a similar rule with respect to annuity payments.

Commentators asked whether a plan may provide for a lump sum payment at the payment date only if the present value of the payments at that date is below a predetermined amount, but continue to make any properly elected installment payments or annuity payments if the present value of the payments at the original payment date is above the predetermined amount, even if the present value of the remaining payments falls below the predetermined amount at a future date. In other words, the cashout threshold would apply only at the time of the original payment date, and not at any future date.

Section 1.409A–2(b)(2)(ii) and (iii) does not provide for this type of payment. However, commentators have asked whether such a provision would be treated as an objective, nondiscretionary payment formula for purposes of § 1.409A–3(b). Section 1.409A–3(b) provides that a plan may provide that a payment upon a qualifying payment event is to be made in accordance with a schedule that is objectively determinable and nondiscretionary based on the date the event occurs and that would qualify as a fixed schedule under § 1.409A–2(i)(1) if the payment event were instead a fixed date, provided that the schedule must be fixed at the time the permissible payment event is designated.

The use of this type of a cashout provision may, in certain circumstances, be subject to manipulation, so that this type of provision is not an objectively determinable and nondiscretionary schedule of payments. However, until further guidance, a taxpayer may treat such a provision as part of an objectively determinable and nondiscretionary payment schedule if the payment schedule would otherwise meet the requirements of the regulations, including that the cashout threshhold be fixed at the time the permissible payment event is designated, and if the taxpayer can demonstrate that the provision operated in an objective, nondiscretionary manner and did not operate so as to provide either the service provider or the service recipient with rights having substantially the effect of a right to a late election as to the time and form of payment. Any subsequent change in a cashout threshold applicable to a deferred amount is subject to the rules governing subsequent deferral elections and the acceleration of payments.

If such a provision is used in conjunction with an installment payment or annuity, the payment schedule generally would not meet the definition of an installment payment or annuity under § 1.409A–2(b)(2)(ii) and (iii), because the payment schedule would not necessarily provide for substantially equal payments over the service provider's lifetime or other predetermined period of time, but instead a lump sum payment if the threshold were not met and periodic payments if the threshold were met. However, until further guidance, the classification of the resulting schedule of payments if the cashout threshold is exceeded at the applicable payment date, whether or not such schedule of payments is intended to be an installment payment or life annuity, is determined as if the lump sum payment cashout threshold were not available. Accordingly, the resulting schedule of payments if the threshold is met must otherwise meet the requirements of § 1.409A–3, and if the resulting schedule of payments qualifies as a life annuity under § 1.409A–2(b)(ii), or as a series of installment payments treated as a single payment under § 1.409A–2(b)(2)(iii), the schedule of payments will be treated as a single payment for purposes of the subsequent deferral rules.

V. ANTICIPATED LIMITED VOLUNTARY COMPLIANCE PROGRAM

The Treasury Department and the IRS anticipate issuing guidance in the near future establishing a limited voluntary compliance program that will apply to certain unintentional operational failures to comply with § 409A. The Treasury Department and the IRS anticipate that such guidance will provide methods by which certain unintentional operational failures may be corrected in the same taxable year in which the operational failure occurred to avoid application of § 409A, and other methods by which certain unintentional operational failures may result in only limited amounts becoming includible in income and subject to additional taxes under § 409A.

VI. APPLICATION OF § 409A(b) (RESTRICTIONS ON CERTAIN TRUSTS AND OTHER ARRANGEMENTS)

Section 409A(b)(1) and (2) generally prohibits the use of offshore trusts in connection with amounts payable under a nonqualified deferred compensation plan, and also prohibits the use of restrictions on assets to protect the payment of benefits under a nonqualified deferred compensation plan in connection with a change in the service recipient's financial health. Section 409A(b)(3) generally also prohibits the transfer of assets to a trust or other arrangement for purposes of paying nonqualified deferred compensation to an applicable covered employee during, or the use of restrictions on assets to protect the payment of benefits under a nonqualified deferred compensation plan in connection with, a restricted period with respect to a single-employer defined benefit plan. For this purpose, a restricted period with respect to a single-employer defined benefit plan generally means any period during which the plan is in at-risk status (as defined in § 430(i), which was added by the Pension Protection Act of 2006), any period the plan sponsor is a debtor in a bankruptcy filing, and the 12-month period beginning on the date which is 6 months before the termination of the defined benefit plan if, as of the termination date, the plan is underfunded. Section 409A(b) provides generally that if these requirements are not met, the assets are treated for purposes of § 83 as property transferred in connection with the performance of services whether or not such assets are available to satisfy claims of general creditors, and that the taxpayer is liable for the additional § 409A taxes on the resulting income inclusion.

Notice 2006–33 provides that until further guidance is issued, taxpayers may rely upon a reasonable, good faith interpretation of § 409A(b) to determine whether the use of a trust or other arrangement causes an amount to be included in income under § 409A(b). The Treasury Department and the IRS intend to issue further guidance regarding the application of § 409A(b). Until such guidance is issued, taxpayers may continue to rely upon a reasonable, good faith interpretation of § 409A(b) to determine whether the use of a trust or other arrangement causes an amount to be included in income under § 409A(b), including the application of § 409A(b)(3) to transfers of assets during restricted periods.

Notice 2006–33 also provides that with respect to assets set aside, transferred or restricted on or before March 21, 2006 so as to be subject to inclusion under § 409A(b)(1) or 409A(b)(2) (grace period assets), taxpayers will be treated as not having triggered the inclusion or additional tax provisions of § 409A(b) if the nonqualified deferred compensation plan comes into conformity on or before December 31, 2007, with the requirements of § 409A(b) and any guidance issued before such date. Nothing in this section curtails this relief; however, this relief is not extended beyond December 31, 2007. Accordingly, for grace period assets, a taxpayer will trigger the income inclusion and additional tax provisions of § 409A(b) if the nonqualified deferred compensation plan is not in conformity with a reasonable, good faith interpretation of § 409A(b) on or after December 31, 2007. If with respect to grace period assets the nonqualified deferred compensation plan is not in conformity with a reasonable, good faith interpretation of § 409A(b) on December 31, 2007, the taxpayer will trigger the income inclusion and additional tax provisions of § 409A(b) on January 1, 2008.

VII. DRAFTING INFORMATION

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Stephen Tackney at (202) 927–9639 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, §§ 1361, 1362; 1.1361–1, 1.1361–3, 1.1362–4, 1.1362–6, 301.9100–1, 301.9100–3.)

Rev. Proc. 2007–62

SECTION 1. PURPOSE

This revenue procedure provides an additional simplified method for taxpayers to request relief for late S corporation elections and supplements Rev. Proc. 2003–43, 2003–1 C.B. 998. In addition, this revenue procedure provides a simplified method for taxpayers to request relief for a late S corporation election and a late corporate classification election intended to be effective on the same date that the S corporation election was intended to be effective and supplements Rev. Proc. 2004–48, 2004–2, C.B. 172. Generally, this revenue procedure provides that certain eligible entities may be granted relief if the entity satisfies the requirements of sections 4 or 5 (as applicable) of this revenue procedure.

SECTION 2. BACKGROUND

.01 *S Corporation Elections*.

(1) *In General*. Section 1361(a)(1) of the Internal Revenue Code (Code) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for that year.

Section 1362(b)(1) provides that a small business corporation may make an election to be an S corporation for any taxable year (A) at any time during the preceding taxable year, or (B) at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year. Section 1.1362–6(a)(2) of the

Income Tax Regulations provides that a small business corporation makes an election to be an S corporation by filing a completed Form 2553, *Election by a Small Business Corporation.*

Under § 1362(b)(3), if an S corporation election is made after the 15th day of the 3rd month of the taxable year and on or before the 15th day of the 3rd month of the following taxable year, then the S corporation election is treated as made for the following taxable year.

(2) *Late S Corporation Elections*. Section 1362(b)(5) provides that if (A) an election under § 1362(a) is made for any taxable year (determined without regard to § 1362(b)(3)) after the date prescribed by § 1362(b) for making the election for the taxable year or no election is made for any taxable year, and (B) the Secretary determines that there was reasonable cause for the failure to timely make the election, the Secretary may treat the election as timely made for the taxable year (and § 1362(b)(3) shall not apply).

Rev. Proc. 97–48, 1997–2 C.B. 521 provides special procedures to obtain automatic relief for certain late S corporation elections. Generally, relief is available in situations in which a corporation intends to be an S corporation, the corporation and its shareholders reported their income consistent with S corporation status for the taxable year the S corporation election should have been made and for every subsequent year, and the corporation did not receive notification from the Internal Revenue Service regarding any problem with the S corporation status within 6 months of the date on which the Form 1120S, *U.S. Income Tax Return for an S Corporation*, for the first year was timely filed.

Rev. Proc. 2003–43 provides, in part, a simplified method for a taxpayer to request relief for a late S corporation election where the entity fails to qualify as an S corporation solely because of the failure to file the election timely with the applicable campus. Under the revenue procedure, certain entities may be granted relief for failing to file the elections in a timely manner if the request for relief is filed within 24 months of the due date of the election.

.02 *Entity Classification Elections*.

(1) *In General*. Section 301.7701–2(a) of the Procedure and Administration Regulations defines a "business entity" as any entity recognized for federal tax purposes that is not properly classified as a trust under § 301.7701–4 or otherwise subject to special treatment under the Code.

Section 301.7701–3(a) provides that a business entity that is not classified as a corporation under § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8) (an "eligible entity") can elect its classification for federal tax purposes.

Section 301.7701–3(b)(1) provides that, except as otherwise provided in paragraph (b)(3) of the section, unless the entity elects otherwise, a domestic eligible entity is (i) a partnership if it has two or more members; or (ii) disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701–3(c)(1) provides that, except as provided in § 301.7701–3(c)(1)(iv) and (v), an eligible entity may elect to be classified other than as provided in § 301.7701–3(b) by filing Form 8832, *Entity Classification Election*, with the campus designated on Form 8832.

Section 301.7701–3(c)(iii) provides that the entity classification election will be effective on the date specified by the entity on the Form 8832 or on the date filed if no date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, the election will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, the election will be effective 12 months after the date the election was filed.

(2) *Late Entity Classification Elections*. Under § 301.9100–1(c), the Commissioner may grant a reasonable extension of time under the rules set forth in §§ 301.9100–2 and 301.9100–3 to make a regulatory election, or a statutory election (but no more than 6 months except in the case of a taxpayer who is abroad), under all subtitles of the Code, except subtitles E, G, H, and I.

Section 301.9100–1(b) defines the term "regulatory election" as an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin.

Requests for relief under § 301.9100–3 will be granted when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.

Rev. Proc. 2002–59, 2002–2 C.B. 615, provides guidance for an entity newly formed under local law that requests relief for a late initial classification election filed by the due date of the entity's first federal income tax return (excluding extensions).

Under § 301.7701–3(c)(1)(v)(C), an eligible entity that timely elects to be an S corporation under § 1362(a)(1) is treated as having made an election to be classified as an association, provided that (as of the effective date of the election under § 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under § 1361(b). Section 301.7701–3(c)(1)(v)(C) further provides that, subject to § 301.7701–3(c)(1)(iv), the deemed election to be classified as an association generally will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election under § 301.7701–3(c)(1)(i), to be classified as other than an association.

Rev. Proc. 2004–48 provides a simplified method for taxpayers to request relief for a late S corporation election and a late corporate classification election which was intended to be effective on the same date the S corporation election was intended to be effective. Under Rev. Proc. 2004–48, generally, certain eligible entities may be granted relief if the requirements of section 4 of the revenue procedure are satisfied. To obtain relief under Rev. Proc. 2004–48, the entity must file a properly completed Form 2553 with the applicable campus within 6 months after the due date for the tax return, excluding extensions, for the first taxable year the entity intended to be an S corporation. Attached to the Form 2553 must be a statement explaining the reason for the failure to file timely the S corporation election and a statement explaining the reason for the failure to file timely the entity classification election.

SECTION 3. SCOPE

.01 *In General*. This revenue procedure supplements Rev. Proc. 2003–43 and provides an additional simplified method for obtaining relief for a late S corporation election, provided that the requirements of section 4 of this revenue procedure are satisfied. This revenue procedure also supplements Rev. Proc. 2004–48 and provides an additional simplified method for obtaining relief for a late S corporation election and a late corporate classification election, provided that the requirements of section 5 of this revenue procedure are satisfied.

Section 4.01 of this revenue procedure provides the eligibility requirements for relief for a late S corporation election, and section 4.02 of this revenue procedure provides the procedural requirements for relief. Section 5.01 of this revenue procedure provides the eligibility requirements for relief for a late S corporation election and a late corporate classification election, and section 5.02 of this revenue procedure provides the procedural requirements for relief.

This revenue procedure provides procedures in lieu of the letter ruling process ordinarily used to obtain relief for a late S corporation election and a late corporate classification election filed pursuant to § 1362(b)(5), § 301.9100–1 and § 301.9100–3. Accordingly, user fees do not apply to corrective actions under this revenue procedure.

.02 *Entities That Fail to Qualify for Relief Under This Revenue Procedure*.

(1) *Rev. Procs. 97–48, 2003–43, and 2004–48*. An entity that does not meet the requirements for relief under this revenue procedure may request relief for a late S corporation election following the procedures of Rev. Proc. 97–48, or Rev. Proc. 2003–43, or, for relief for a late S corporation election and a late corporate classification election following the procedures of Rev. Proc. 2004–48.

(2) *Letter Rulings*. If an entity does not qualify for relief for a late S corporation election, or relief for a late S corporation election and a late corporate classification election, under Rev. Proc. 97–48, Rev. Proc. 2003–43, or Rev. Proc. 2004–48, as appropriate, the entity may request relief by requesting a letter ruling. The Service will not ordinarily issue a letter ruling if the period of limitations on assessment under § 6501(a) has lapsed for any taxable year for which an election should have been made or any taxable year that would have been affected by the election had it been timely made. The procedural requirements for requesting a letter ruling are described in Rev. Proc. 2007–1, 2007–1 I.R.B. 1 (or its successor).

SECTION 4. RELIEF FOR LATE S CORPORATION ELECTION UNDER THIS REVENUE PROCEDURE

.01 *Eligibility for Relief*. An entity may request relief under this revenue procedure if the following requirements are met:

(1) The entity fails to qualify for its intended status as an S corporation on the first day that status was desired solely because of the failure to file a timely Form 2553 with the applicable campus;

(2) The entity has reasonable cause for its failure to file a timely Form 2553;

(3) The entity seeking to make the S corporation election has not filed a tax return for the first taxable year in which the election was intended;

(4) The application for relief is filed under this revenue procedure no later than 6 months after the due date of the tax return (excluding extensions) of the entity seeking to make the election for the first taxable year in which the election was intended; and

(5) No taxpayer whose tax liability or tax return would be affected by the S corporation election (including all shareholders of the S corporation) has reported inconsistently with the S corporation election, on any affected return for the year the S corporation election was intended.

.02 *Procedural Requirements for Relief*.

An entity may request relief for a late S corporation election by filing with the applicable campus a properly completed Form 2553 (*see* Form 2553 and Instructions) with a Form 1120S for the first taxable year the entity intended to be an S corporation. A properly completed Form 2553 includes a statement establishing reasonable cause for the failure to file the S corporation election timely. The Form 2553 will be modified to allow for the inclusion of such statement. The forms must be filed together no later than 6 months after the due date of the tax return (excluding extensions) of the entity for the first taxable year in which the S corporation election was intended. These items constitute the application requesting relief.

.03 *Relief for Late S Corporation Election*. Upon receipt of a completed application requesting relief under section 4.02 of this revenue procedure, the Service will determine whether the requirements for granting relief for the late S corporation election have been satisfied.

SECTION 5. RELIEF FOR LATE S CORPORATION ELECTION AND LATE CORPORATE CLASSIFICATION ELECTION UNDER THIS REVENUE PROCEDURE

.01 *Eligibility for Relief*. An entity may request relief under this revenue procedure if the following requirements are met:

(1) The entity is an eligible entity as defined in § 301.7701–3(a);

(2) The entity intended to be classified as a corporation as of the intended effective date of the S corporation status;

(3) The entity fails to qualify as a corporation solely because Form 8832 was not timely filed under § 301.7701–3(c)(1)(i), or Form 8832 was not deemed to have been filed under § 301.7701–3(c)(1)(v)(C);

(4) In addition to section 5.01(3) of this section, the entity fails to qualify as an S corporation on the intended effective date of the S corporation status solely because the S corporation election was not timely filed pursuant to § 1362(b);

(5) The entity has reasonable cause for its failure to file a timely Form 2553 and a timely Form 8832;

(6) The entity seeking to make the S corporation election has not filed a tax return for the first taxable year in which the election was intended;

(7) The application for relief is filed under this revenue procedure no later than 6 months after the due date of the S corporation return (excluding extensions) of the entity seeking to make the election for the first taxable year in which the election was intended, and

(8) No taxpayer whose tax liability or tax return would be affected by the S corporation election (including all shareholders of the S corporation) has reported inconsistently with the S corporation election, on any affected return for the year the S corporation election was intended.

.02 *Procedural Requirements for Relief.*

An entity may request relief for a late S corporation election and a late corporate classification election by filing a properly completed Form 2553 (*see* Form 2553 and Instructions) with a Form 1120S for the first taxable year the entity intended to be an S corporation. A properly completed Form 2553 includes a statement explaining the reason for the failure to file the S corporation election timely and a statement explaining the reason for the failure to file the entity classification election timely. The Form 2553 will be modified to allow for the inclusion of such statements. The forms must be filed together no later than 6 months after the due date of the tax return (excluding extensions) of the entity for the first taxable year in which the S corporation election was intended. These items constitute the application requesting relief.

.03 *Relief for Late S Corporation Election and Late Corporate Classification Election.* Upon receipt of a completed application requesting relief under section 5.02 of this revenue procedure, the Service will determine whether the requirements for granting relief for the late S corporation election and late corporate classification election have been satisfied. An entity receiving relief under this revenue procedure is treated as having made an election to be classified as an association taxable as a corporation under § 301.7701–3(c) as of the effective date of the S corporation election.

SECTION 6. EFFECT ON OTHER DOCUMENTS

This revenue procedure supplements Rev. Procs. 2003–43 and 2004–48.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for S corporation elections and corporate classification elections intended to be effective for taxable years that end on or after December 31, 2007.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jian H. Grant of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Grant at (202) 622–3050 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Regulations and Notice of Public Hearing

Partner's Distributive Share

REG–143397–05

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains regulations that provide rules concerning the application of sections 704(c)(1)(B) and 737 to distributions of property after two partnerships engage in an assets-over merger. The proposed regulations affect partnerships and their partners. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by November 20, 2007. Outlines of the topic to be discussed at the public hearing scheduled for December 5, 2007 at 10 a.m. must be received by November 21, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–143397–05), 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–143397–05), 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–143397–05). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jason Smyczek or Laura Fields (202) 622–3050, concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Richard Hurst, *Richard.A.Hurst@irscounsel.treas.gov*, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 704(c)(1)(B) provides that a partner that contributes section 704(c) property to a partnership must recognize gain or loss on the distribution of such property to another partner within seven years of its contribution to the partnership in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c) if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution.

Section 737(a) provides that a partner that contributes section 704(c) property to the partnership and then receives a distribution of property (other than money) within seven years of its contribution must recognize gain in an amount equal to the lesser of (1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of the partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or (2) the net precontribution gain of the partner.

Section 737(b) provides that for purposes of section 737, the term "net precontribution gain" means the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if all property which (1) had been contributed to the partnership by the distributee partner within seven years of the distribution, and (2) is held by the partnership immediately before the distribution, had been distributed by the partnership to another partner.

Rev. Rul. 2004–43, 2004–1 C.B. 842, (see §601.601(d)(2) of this chapter) issued on April 12, 2004, addressed the application of sections 704(c)(1)(B) and 737 in an assets-over partnership merger described in §1.708–1(c)(3). Rev. Rul. 2004–43 held that section 704(c)(1)(B) applies to newly created section 704(c) gain or loss in property contributed by the transferor partnership to the transferee partnership in an assets-over partnership merger. The revenue ruling also held that for purposes of section 737(b), net precontribution gain includes newly created section 704(c) gain or loss in property contributed by the transferor partnership to the transferee partnership in an assets-over partnership merger. In addition, the revenue ruling held that section 704(c)(1)(B) will not apply to, and, for purposes of section 737, net precontribution gain will not include, reverse section 704(c) gain or loss resulting from a revaluation of property of the transferee partnership.

Some commentators argued that Rev. Rul. 2004–43 was not consistent with the existing regulations under sections 704(c)(1)(B) and 737, and that the conclusions contained in the ruling should not be applied retroactively. In response to these comments, the Treasury Department and the IRS issued Notice 2005–15, 2005–1 C.B. 527, (see §601.601(d)(2) of this chapter) indicating their intent to issue regulations under sections 704(c)(1)(B) and 737 implementing the principles of the ruling, and issued Rev. Rul. 2005–10, 2005–1 C.B. 492, (see §601.601(d)(2) of this chapter) officially revoking Rev. Rul. 2004–43. The notice provided that any such regulations would be effective for distributions made after January 19, 2005.

Explanation of Provisions

A. Assets-Over Partnership Mergers

These proposed regulations implement the principles articulated in Rev. Rul. 2004–43. The proposed regulations under §1.704–4(c)(4) and §1.737–2(b) provide that in an assets-over merger, sections 704(c)(1)(B) and 737 do not apply to the transfer by a partnership (the transferor partnership) of all of its assets and liabilities to another partnership (the transferee partnership), followed by a distribution of the interests in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.

The proposed regulations, however, provide that section 704(c)(1)(B) applies to a subsequent distribution by the transferee partnership of section 704(c) property contributed in the assets-over merger by the transferor partnership to

the transferee partnership. The proposed regulations also provide that section 737 applies when a partner of the transferor partnership receives a subsequent distribution of property (other than money) from the transferee partnership.

The proposed regulations provide that for property contributed to the transferor partnership (original contribution), the amount of original section 704(c) gain or loss is the difference between the property's fair market value and the contributing partner's adjusted basis at the time of contribution to the extent such difference has not been eliminated by section 704(c) allocations, prior revaluations, or in connection with the merger. In the case of property contributed with original section 704(c) loss, section 704(c)(1)(C) which was added by the American Jobs Creation Act of 2004 provides special rules for determining the basis of the property contributed. The Treasury Department and IRS are currently developing guidance that will implement the provisions of section 704(c)(1)(C). Thus, the proposed regulations do not address the impact of section 704(c)(1)(C) in applying these rules. However, when finalized, these regulations will clarify the application of section 704(c)(1)(C) to these rules.

The proposed regulations provide that the seven year period will not restart with respect to the original section 704(c) gain or loss as a result of the merger. Accordingly, a subsequent distribution by the transferee partnership of property with original section 704(c) gain or loss is subject to sections 704(c)(1)(B) and 737 if the distribution occurs within seven years of the contribution of the property to the transferor partnership (original contribution). However, with respect to new section 704(c) gain or loss, the regulations provide that the seven-year period in sections 704(c)(1)(B) and 737 begins on the date of merger. Thus, a subsequent distribution by the transferee partnership of property with new section 704(c) gain or loss is subject to sections 704(c)(1)(B) and 737 if the distribution occurs within seven years of the merger.

The regulations further provide that no original section 704(c) gain or loss will be recognized under section 704(c)(1)(B) or section 737 if property that was originally contributed to the transferor partnership is distributed to the original contributor. If property has new section 704(c) gain or loss, then a subsequent distribution of such property within seven years of the merger to one of the former partners of the transferor partnership (former partner) is subject to section 704(c)(1)(B) only to the extent of the other former partners' shares of such gain or loss.

New section 704(c) gain or loss shall be allocated among the partners of the transferor partnership in a manner consistent with the principles of §§1.704–3(a)(7) and newly designated 1.704–3(a)(10) (previously §1.704–3(a)(9)). In addition, the partners of the transferor partnership are deemed to have contributed an undivided interest in the assets of the partnership. The proposed regulations provide that the determination of the partners' undivided interest for this purpose shall be made by the transferor partnership using any reasonable method. The Treasury Department and the IRS request comments on methods that should be considered reasonable for this purpose.

The proposed regulations also provide that if less than all of a section 704(c) property is distributed, then a proportionate amount of original and new section 704(c) gain or loss must be recognized under section 704(c)(1)(B). Similarly, if gain is required to be recognized under section 737, a proportionate amount of original and new section 704(c) gain must be recognized under section 737. Each partner must recognize its respective proportionate share of gain or loss required to be recognized.

The proposed regulations further provide a subsequent merger rule. This rule provides that if the transferee partnership is subsequently merged (a subsequent merger) the new section 704(c) gain or loss that resulted from the original merger shall be subject to section 704(c)(1)(B) for seven years from the time of the original merger and the new section 704(c) gain or loss that resulted from the subsequent merger will be subject to section 704(c)(1)(B) for seven years from the time of the subsequent merger.

In addition, the proposed regulations provide an identical ownership and a *de minimis* change in ownership exception to sections 704(c)(1)(B) and 737 with regard to assets-over partnership mergers. Under the identical ownership exception, section 704(c)(1)(B) will not apply to, and section 737 net precontribution gain will not include, new section 704(c) gain or loss in any property contributed in an assets-over partnership merger where the ownership of both partnerships is identical. In order for merging partnerships to qualify for the identical ownership exception, each partner must own identical interests in book capital and in each item of income, gain, loss, deductions and credit, and identical shares of distributions and liabilities in each of the transferor and transferee partnerships. Where ownership of both partnerships is identical, the merger more accurately represents a change in form, and should have no substantive tax consequences. The same principles apply where the change in ownership is *de minimis*. For purposes of the *de minimis* exception, a difference in ownership is *de minimis* if ninety seven percent of the interests in book capital, items of income, gain, loss, deduction and credit and share of distributions and liabilities of the transferor partnership and transferee partnership are owned by the same owners in the same proportions.

Proposed regulations under §1.704–3(c)(4)(iii) provide that taxpayers may distinguish between the original and new portions of section 704(c) gain or loss. The proposed regulations provide that the transferee partnership may continue to use the section 704(c) allocation method adopted by the transferor partnership with respect to original section 704(c) property, or it may adopt another reasonable section 704(c) method. In addition, the transferee partnership may adopt any reasonable section 704(c) method with respect to new section 704(c) gain or loss. With respect to both the original and the new section 704(c) gain or loss, the transferee partnership must use a reasonable method that is consistent with the purpose of sections 704(b) and 704(c).

B. Miscellaneous Provisions

As part of this proposed regulation, the Treasury Department and the IRS are also making certain regulatory changes to reflect statutory changes that occurred as part of the Taxpayer Relief Act of 1997 (Public Law 105–34). Effective June 8, 1997, Congress lengthened the period of time from five years to seven for accounting for section 704(c) gain or loss

with respect to distributions. Consistent with the statutory changes, various provisions in §1.704–4 and §1.737–1 have been amended.

Effective Dates

Except as otherwise provided, these proposed regulations will be effective for any distributions of property after January 19, 2005, if such property was contributed in an assets-over merger after May 3, 2004. Provisions relating to the change in the regulations in §1.704–4 and §1.737–1 from the previous five-year rule to the seven-year rule will be effective August 22, 2007.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the 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 comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and IRS request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for **December 5, 2007**, 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., 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 15 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 written or electronic comments by November 20, 2007, and an outline of the topics to be discussed and time to be devoted to each topic (a signed original and eight (8) copies) by November 21, 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 authors of these proposed regulations are Jason Smyczek and Laura Fields, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART—INCOME TAXES

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

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

Section 1.704–3 also issued under 26 U.S.C. 704. * * *

Par. 2. Section 1.704–3 is amended as follows:

1. Paragraphs (a)(9) through (a)(12) are redesignated as paragraphs (a)(10) through (a)(13), respectively.

2. New paragraph (a)(9) is added.

3. Paragraph (f) is amended by revising the paragraph heading and adding one additional sentence at the end of the paragraph.

The revisions and additions read as follows:

§1.704–3 Contributed Property.

(a)* * *

(9) *Section 704(c) property transferred in an assets-over merger.* Assets transferred to a transferee partnership from the transferor partnership in an assets-over merger as defined in §1.708–1(c)(3) (the transferor partnership being the partnership considered to have been terminated under §1.708–1(c)(1) and the transferee partnership being the partnership considered to be the resulting partnership under §1.708–1(c)(1)) may have both original section 704(c) gain or loss (see §1.704–4(c)(4)(ii)(A) for the definition of original section 704(c) gain or loss) and new section 704(c) gain or loss. The transferee partnership may continue to use the section 704(c) allocation method adopted by the transferor partnership with respect to section 704(c) property originally contributed to the transferor partnership or it may adopt another reasonable section 704(c) method. Also, the transferee partnership may continue to use the section 704(c) allocation method adopted by the transferor partnership with respect to new section 704(c) gain or loss to account for differences between book value and adjusted tax basis as a result of a prior revaluation. In addition, the transferee partnership may adopt any reasonable section 704(c) method with respect to new section 704(c) gain or loss in excess of the amount of new section 704(c) gain or loss described in the prior sentence. With respect to both original and new section 704(c) gain or loss, the transferee partnership must use a reasonable method that is consistent with the purpose of sections 704(b) and 704(c).

* * *

(f) *Effective/applicability date.* * * * Paragraph (a)(9) is effective for any distribution of property after January 19, 2005, if such property was contributed in a merger using the assets-over form after May 3, 2004.

Par. 3. Section 1.704–4 is amended as follows:

1. Paragraph (a)(1) is amended by removing the phrase "five years" and adding in its place the phrase "seven years."

2. Paragraph (a)(4)(i) is amended by removing the phrase "five-year" and adding in its place the phrase "seven-year."

3. Paragraph (a)(4)(ii) is amended by removing the phrase "five-year" and adding in its place the phrase "seven-year."

4. Paragraphs (c)(4)(i) and (c)(4)(ii) are added.

5. Paragraph (c)(7) is redesignated as paragraph (c)(8).

6. A new paragraph (c)(7) is added.

7. Paragraphs (f)(2), Examples (1) and (2) are amended by removing the language "five-year" and replacing it with the language "seven-year" wherever it appears throughout both examples.

8. Paragraph (g) is amended by revising the paragraph heading and adding two sentences at the end of the paragraph.

The revisions and additions read as follows:

§1.704–4 Distribution of contributed property.

* * * * *

(c) * * *

(4) *Complete transfer to another partnership (Assets-Over Merger).* (i) *In general.* Section 704(c)(1)(B) and this section do not apply to the transfer in an assets-over merger as defined in §1.708–1(c)(3) by a partnership (the transferor partnership, which is considered to be the terminated partnership as a result of the merger) of all of its assets and liabilities to another partnership (the transferee partnership, which is considered to be the resulting partnership after the merger), followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.

(ii) *Subsequent distributions.* Except as provided in paragraph (c)(4)(E) below, section 704(c)(1)(B) and this section apply to the subsequent distribution by the transferee partnership of section 704(c) property contributed by the transferor partnership to the transferee partnership in an assets-over merger, as provided in paragraphs (c)(4)(ii)(A) through (D) of this section.

(A) *Original section 704(c) gain or loss.* The seven-year period in section 704(c)(1)(B) does not restart with respect to original section 704(c) gain or loss as a result of the transfer of the section 704(c) property to the transferee partnership. For purposes of this paragraph (c)(4)(ii)(A), the amount of original section 704(c) gain or loss is the difference between the property's fair market value and the contributing partner's adjusted tax basis, at the time of contribution, to the extent such difference has not been eliminated by section 704(c) allocations, prior revaluations, or in connection with the merger. See §§1.704–4(a) and (b) for post-merger distributions of property contributed to the transferee partnership prior to the merger. A subsequent distribution by the transferee partnership of property with original section 704(c) gain or loss to a partner other than the partner that contributed such property to the transferor partnership is subject to section 704(c)(1)(B) if the distribution occurs within seven years of the contribution of the property to the transferor partnership. See §1.704–4(c)(4)(ii)(B) for rules relating to the distribution of property with new section 704(c) gain or loss. See §1.737–2(b)(1)(ii)(A) for a similar rule in the context of section 737.

(B) *New section 704(c) gain or loss.* A subsequent distribution of property with new section 704(c) gain or loss by the transferee partnership to a partner other than the contributing partner is subject to section 704(c)(1)(B) if the distribution occurs within seven years of the contribution of the property to the transferee partnership by the transferor partnership. For these purposes, a partner of the transferor partnership is deemed to have contributed to the transferee partnership an undivided interest in the property of the transferor partnership. The determination of the partners' undivided interest for this purpose shall be determined by the transferor partnership using any reasonable method. New section 704(c) gain or loss shall be allocated among the partners of the transferor partnership in a manner consistent with the principles of §§1.704–3(a)(7) and 1.704–3(a)(10). See §1.737–2(d)(4) for a similar rule in the context of section 737.

(C) *Ordering Rule.* (1) *Post-merger revaluation.* Revaluations after a merger that reflect a reduction in the amount of built-in gain or loss inherent in property will reduce new section 704(c) gain or loss prior to reducing original section 704(c) gain or loss.

(2) *Post-merger partial recognition.* For purposes of this section, if less than all of a section 704(c) property is distributed, then a proportionate amount of original and new section 704(c) gain or loss must be recognized.

(D) *Subsequent Mergers.* If the transferee partnership (first transferee partnership) is subsequently merged into another partnership (new transferee partnership) the new section 704(c) gain or loss that resulted from the merger of the transferor partnership into the first transferee partnership shall be subject to section 704(c)(1)(B) for seven years from the time of the contribution by the transferor partnership to the first transferee partnership (original merger) and new section 704(c) gain or loss that resulted from the merger of the first transferee into the new transferee (subsequent merger) shall be subject to section 704(c)(1)(B) for seven years from the time of the subsequent merger. See §1.737–2(b)(1)(ii)(D) for a similar rule in the context of section 737.

(E) *Identical Ownership or De Minimis Change in Ownership Exception.* Section 704(c)(1)(B) and this section do not apply to new section 704(c) gain or loss in property transferred by the transferor partnership to the transferee partnership if both the transferor partnership and the transferee partnership are owned by the same owners in the same proportions or the difference in ownership is *de minimis.* The transferor partnership and the transferee partnership are owned by the same owners in the same proportions if each partner owns identical interests in book capital and in each item of income, gain, loss, deduction, and credit, and identical shares of distributions and liabilities in each of the transferor and transferee partnerships. A difference in ownership is *de minimis* if ninety seven percent of the interests in book capital and in each item of income, gain, loss, deduction and credit and shares of distributions, and liabilities of the transferor partnership and transferee partnership are owned by the same owners in the same proportions.

(F) *Examples.* The following examples illustrate the rules of paragraph (c)(4)(ii) of this section.

Example (1). New section 704(c) gain. (i) *Facts.* On January 1, 2005, A contributes Asset 1, with a

basis of $200x and a fair market value of $300x, to partnership PRS1 in exchange for a 50 percent interest. On the same date, B contributes $300x of cash to PRS1 in exchange for a 50 percent interest. Also on January 1, 2005, C contributes Asset 2, with a basis of $100x and a fair market value of $200x, to partnership PRS2 in exchange for a 50 percent interest. D contributes $200x of cash to PRS2 in exchange for a 50 percent interest. On January 1, 2008, PRS1 and PRS2 undertake an assets-over partnership merger in which PRS1 is the continuing partnership and PRS2 is the terminating partnership for both state law and federal tax purposes. At the time of the merger, PRS1's only assets are Asset 1, with a fair market value of $900x, and $300x in cash. PRS2's only assets are Asset 2, with a fair market value of $600x, and $200x in cash. After the merger, the partners have book capital and profits interests in PRS1 as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. PRS1 and PRS2 both have provisions in their respective partnership agreements requiring the revaluation of partnership property upon entry of a new partner. PRS1 would not be treated as an investment company (within the meaning of section 351) if it were incorporated. Neither partnership holds any unrealized receivables or inventory for purposes of section 751. In addition, neither partnership has a section 754 election in place. Asset 1 and Asset 2 are nondepreciable capital assets. On January 1, 2013, PRS1 has the same assets that it had after the merger. Each asset has the same value that it had at the time of the merger. On this date, PRS1 distributes Asset 2 to A in liquidation of A's interest.

(ii) *Analysis*. On the date of the merger of PRS2 into PRS1, the fair market value of Asset 2 ($600x) exceeded its adjusted tax basis ($100x). Thus, pursuant to §1.704–4(c)(4)(ii)(A), when Asset 2 was contributed to PRS1 in the merger, it was section 704(c) gain property. The total amount of the section 704(c) gain was $500x ($600x (fair market value) - $100x (adjusted basis)). The amount of original section 704(c) gain attributable to Asset 2 equals $100x, the difference between its fair market value ($200x) and adjusted tax basis ($100x) upon contribution to PRS2 by C. The amount of new section 704(c) gain attributable to Asset 2 equals $400x, the total amount of section 704(c) gain ($500x) less the amount of the original section 704(c) gain ($100x). The distribution of Asset 2 to A occurs more than seven years after the contribution by C of Asset 2 to PRS2. Therefore, pursuant to §1.704–4(c)(4)(ii)(A), section 704(c)(1)(B) does not apply to the $100x of original section 704(c) gain. The distribution of Asset 2 to A, however, occurs within seven years of the contribution in the merger of Asset 2 to PRS1 by PRS2. Pursuant to §1.704–4(c)(4)(ii)(B), section 704(c)(1)(B) applies to the new section 704(c) gain. As the transferees of PRS2's partnership interest in PRS1, C and D succeed to one-half of the $400x of the new section 704(c) gain created by the merger. Thus, as a result of the distribution of Asset 2 to A within seven years of the merger, C and D are required to recognize $200x of gain each. See §1.737–2(b)(1)(ii)(F), *Example (1)* for analysis of a similar example under section 737.

Example (2). Revaluation gain and merger gain. (i) *Facts.* The facts are the same as *Example (1)*, except that during 2005, PRS2 admitted E as a new partner in PRS2 at a time when the fair market value of Asset 2 was $300x and PRS2's only other asset was cash of $200x. In exchange for a contribution of cash of $250x, E was admitted as a one-third partner in PRS2. In accordance with the terms of PRS2's partnership agreement, the partnership revalued its assets pursuant to §1.704–1(b)(2)(iv)(f) upon admission of E so that the unrealized gain of $100x attributable to Asset 2 was allocated equally between C and D, or $50x each. On January 1, 2008, PRS2 merges into PRS1. At the time of the merger, PRS1's only assets are Asset 1, with a fair market value of $550x, and $300x in cash. PRS2's only assets are Asset 2, with a fair market value of $400x, and $450x in cash. After the merger, the partners have book capital and profits and loss interests in PRS1 as follows: A, 25%; B, 25%; C, 16.67%; D, 16.67% and E, 16.67%. On January 1, 2011, Asset 2 is distributed to A when its value is still $400x.

(ii) Analysis. On the date of the merger of PRS2 into PRS1, the fair market value of Asset 2 ($400x) exceeded its adjusted tax basis ($100x). Thus, when Asset 2 was contributed to PRS1 in the merger, it was section 704(c) gain property. The total amount of the section 704(c) gain was $300x ($400x (fair market value) - $100x (adjusted basis)). The amount of the original section 704(c) gain attributable to Asset 2 equals $100x, the difference between its fair market value of $200x and adjusted tax basis $100x upon contribution to PRS2 by C. The amount of the new section 704(c) gain attributable to Asset 2 equals $200x, the total section 704(c) gain ($300x) less the amount of the original section 704(c) gain ($100x). The distribution of Asset 2 to A occurs within seven years after the contribution by C to PRS2. Therefore, pursuant to §1.704–4(c)(4)(ii)(A), section 704(c)(1)(B) applies to the original section 704(c) gain. The distribution of Asset 2 to A also occurs within seven years of the contribution of Asset 2 to PRS1 by PRS2. Pursuant to §1.704–4(c)(4)(ii)(B), section 704(c)(1)(B) applies to the new section 704(c) gain. As the transferees of PRS2's partnership interest in PRS1, C and D each succeed to $50x of new section 704(c) gain as a result of the revaluation of Asset 2 upon admission of E as a partner. Moreover, C, D and E each succeed to $33.33x of new section 704(c) gain as a result of the merger. C also has $100 of original section 704(c) gain as a result of the original contribution of Asset 2 to PRS2. Thus, as a result of the distribution of Asset 2 to A within seven years of the merger, C, D and E are each required to recognize gain. C will recognize a total of $183.33x of gain ($100x of original section 704(c) gain and $83.33x of new section 704(c) gain). D will recognize a total of $83.33x of gain (all new section 704(c) gain) and E will recognize $33.33x of gain (all new section 704(c) gain). See §1.737–2(b)(1)(ii)(F), *Example (2)* for a similar example under section 737.

Example (3). Revaluation loss and merger gain. (i) *Facts*. The facts are the same as *Example (1)* except that during 2005, PRS2 admitted E as a new partner in PRS2 at a time when the fair market value of Asset 2 was $150x and PRS2's only other asset was cash of $200x. In exchange for a contribution of cash of $175x, E was admitted as a one-third partner in PRS2. In accordance with the terms of PRS2's partnership agreement, the partnership revalued its assets upon admission of E so that the unrealized loss of $50x attributable to Asset 2 was allocated equally between C and D, or $25x each. On January 1, 2008, PRS 2 merges into PRS1. At the time of the merger, PRS1's only assets are Asset 1, with a fair market value of $900x, and $300x in cash. PRS2's only assets are Asset 2, with a fair market value of $600x, and $375x in cash. After the merger, the partners have book capital and profits and loss interests in PRS1 as follows: A, 27.5%; B, 27.5%; C, 15%; D, 15% and E, 15%. On January 1, 2013, Asset 2 is distributed to A when its value is still $600.

(ii) *Analysis*. On the date of the merger of PRS2 into PRS1, the fair market value of Asset 2 ($600x) exceeded its adjusted tax basis ($100x). Thus, when Asset 2 was contributed to PRS1 in the merger, it was section 704(c) gain property. The total amount of the section 704(c) gain was $500x ($600x (fair market value) - 100x (adjusted basis)). The amount of the original section 704(c) gain attributable to Asset 2 equals $50x, the difference between its fair market value ($200x) and adjusted tax basis ($100x) upon contribution to PRS2 by C, less the unrealized loss ($50X) attributable to the revaluation of PRS2 on the admission of E as a partner in PRS2. The amount of the new section 704(c) gain attributable to Asset 2 equals $450x, the total section 704(c) gain ($500x) less the amount of the original section 704(c) gain ($50x). The distribution of Asset 2 to A occurs more than seven years after the contribution by C to PRS2. Therefore, pursuant to §1.704–4(c)(4)(ii)(A), section 704(c)(1)(B) does not apply to the original section 704(c) gain. The distribution of Asset 2 to A, however, occurs within seven years of the contribution of Asset 2 to PRS1 and PRS2. Pursuant to §1.704–4(c)(4)(ii)(B), section 704(c)(1)(B) applies to the new section 704(c) gain. As the transferees of PRS2's partnership interest in PRS1, C, D and E each succeed to $150 of new section 704(c) gain. Thus, as a result of the distribution of Asset 2 to A within seven years of the merger, C, D and E are each required to recognize $150 of gain.

Example (4). Reverse section 704(c) gain. (i) *Facts*. The facts are the same as *Example (1)*, except that on January 1, 2013, PRS1 distributes Asset 1 to C in liquidation of C's interest in PRS1.

(ii) *Analysis*. The distribution of Asset 1 to C occurs more than seven years after the contribution of Asset 1 to PRS1. Thus, pursuant to §1.704–4(c)(4)(ii)(A), section 704(c)(1)(B) does not apply to the original section 704(c) gain. Pursuant to §1.704–4(c)(7), section 704(c)(1)(B) does not apply to reverse section 704(c) gain in Asset 1 resulting from a revaluation of PRS1's partnership property at the time of the merger. Accordingly, neither A nor B will recognize gain under section 704(c)(1)(B) as a result of the distribution of Asset 1 to C. See §1.737–2(b)(1)(ii)(F), *Example (4)* for a similar example under section 737.

Example (5). Identical ownership exception. (i) *Facts*. In 1990, A, an individual, and B, a subchapter C corporation, formed PRS1, a partnership. A owned 75 percent of the interests in the book capital (as determined for purposes of §1.704–1(b)(2)(iv)), profits, losses, distributions, and liabilities (under section 752) of PRS1. B owned the remaining 25 percent interest in the book capital, profits, losses, distributions, and liabilities of PRS1. In the same year, A and B also formed another partnership, PRS2, with A owning 75 percent of the interests in the book capital, profits, losses, distributions, and liabilities of PRS2 and B owning the remaining 25 percent of the book capi-

tal, profits, losses, distributions, and liabilities. Upon formation of the partnerships, A contributed the Asset X to PRS1 and Asset Y to PRS2 and B contributed cash. Both Assets X and Y had section 704(c) built-in gain at the time of contribution to the partnerships.

(ii) In January 2005, PRS1 is merged into PRS2 in an assets-over merger in which PRS1 is the terminating partnership and PRS2 as the continuing partnership for both state law and federal income tax purposes. At the time of the merger, both Asset X and Y had increased in value from the time they were contributed to PRS1 and PRS2, respectively. As a result, a new layer of section 704(c) gain was created with respect to Asset X in PRS1, and reverse section 704(c) gain was created with respect to Asset Y in PRS2. After the merger, A had a 75 percent interest in PRS2's capital, profits, losses, distributions, liabilities, and all other items. B held the remaining 25 percent interest in PRS2's capital, profits, losses, distributions, liabilities, and all other items. In 2006, PRS2 distributes all of Asset X to A.

(iii) *Analysis*. The 2006 distribution of Asset X occurs more than seven years after the formation of the partnerships and the original contribution of both Assets X and Y to the partnerships. Therefore, the original layer of built-in gain created on the original contribution of Asset X to PRS1 is not taken into account in applying section 704(c)(1)(B) to the proposed distribution. In addition, paragraph (c)(4)(ii)(E) of this section provides that section 704(c)(1)(B) and paragraph (c)(4)(ii)(B) of this section do not apply to new section 704(c) gain or loss in property transferred by the transferor partnership to the transferee partnership if both the transferor partnership and the transferee partnership are owned by the same owners in the same proportions. The transferor partnership and the transferee partnership are owned by the same owners in the same proportions if each partner's percentage interest in the transferor partnership's book capital, profits, losses, distributions, and liabilities, is the same as the partner's percentage interest in those items of the transferee partnership. In this case, A owned 75 percent and B owned 25 percent of the interests in the book capital, and in each item of income, gain, loss and credit, and share of distributions and liabilities of PRS1 and PRS2 prior to the merger and 75 percent and 25 percent, respectively, of PRS2 after the merger. As a result, the requirements of the identical ownership exception of paragraph (c)(4)(ii)(E) of this section are satisfied. Thus, the new built-in gain created upon contribution of Asset X in connection with the partnership merger will not be taken into account in applying section 704(c)(1)(B) to the proposed distribution. See §1.737–2(b)(1)(ii)(F), *Example (5)* for a similar example under section 737.

* * *

(7) *Reverse section 704(c) gain or loss*. Section 704(c)(1)(B) and this section do not apply to reverse section 704(c) gain or loss as described in §1.704–3(a)(6)(i).

* * * * *

(g) *Effective/applicability date*. * * * Paragraphs (a)(1), (a)(4)(i), (a)(4)(ii), and (f)(2), *Examples (1) and (2),* are effective August 20, 2007. Paragraphs (c)(4) and (c)(7) are effective for any distributions of property after January 19, 2005, if such property was contributed in a merger using the assets-over form after May 3, 2004.

Par. 4. Section 1.737–1(c)(1) is amended by removing the phrase "five years" and adding in its place the phrase "seven years."

Par. 5. Section 1.737–2 is amended as follows:

1. Paragraph (b) is revised.

2. Paragraph (e) is redesignated as paragraph (f).

3. New paragraph (e) is added.

The additions and revisions read as follows:

§1.737–2 Exceptions and special rules.

* * * * *

(b) *Transfers to another partnership*. (1) *Complete transfer to another partnership (Assets-over merger)*. (i) *In General*. Section 737 and this section do not apply to a transfer in an assets-over merger as defined in §1.708–1(c)(3) by a partnership (the transferor partnership, which is considered to be the terminated partnership as a result of the merger) of all of its assets and liabilities to another partnership (the transferee partnership, which is considered to be the resulting partnership after the merger) followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.

(ii) *Subsequent distributions*. (A) *Original section 704(c) gain*. If, immediately before the assets-over merger, the transferor partnership holds property that has original built-in gain (as defined in §1.704–4(c)(4)(ii)(A)), the seven year period in section 737(b) does not restart with respect to such gain as a result of the transfer of such section 704(c) property to the transferee partnership. A subsequent distribution of other property by the transferee partnership to the partner who contributed the original section 704(c) gain property to the transferor partnership is only subject to section 737 with respect to the original section 704(c) gain if the distribution occurs within seven years of the time such property was contributed to the transferor partnership. See §1.704–4(c)(4)(ii)(A) for a similar provision in the context of section 704. See §1.737–1 for post-merger distribution of property contributed to the transferee partnership prior to the merger.

(B) *New section 704(c) gain*. Except as provided in paragraph (b)(1)(ii)(E) of this section, if new built-in gain is created upon the contribution of assets by the transferor partnership to the transferee partnership, a subsequent distribution by the transferee partnership of property to a partner of the transferee partnership (other than property deemed contributed by such partner) is subject to section 737, if such distribution occurs within seven years of the contribution by the transferor partnership to the transferee partnership. For these purposes, a partner of the transferor partnership is deemed to have contributed to the transferee partnership an undivided interest in the property of the transferor partnership. The determination of the partner's undivided interest for this purpose shall be determined by the transferor partnership using any reasonable method. See §1.704–4(c)(4)(ii)(B) for a similar provision in the context of section 704.

(C) *Ordering Rule*. For purposes of this section, if a partner is required to recognize gain under this section, the partner shall recognize a proportionate amount of original and new section 704(c) gain.

(D) *Subsequent Mergers*. If the transferee partnership (first transferee partnership) is subsequently merged into another partnership (new transferee partnership) the section 704(c) gain that resulted from the merger of the transferor partnership into the first transferee partnership shall be subject to section 737 for seven years from the time of the contribution by the transferor partnership to the first transferee partnership (original merger) and section 704(c) gain that resulted from the merger of the first transferee partnership into the new transferee partnership shall be subject to section 737 for seven years from the time of the contribution by the first transferee partnership to the new transferee partnership (subsequent merger). See §1.704–4(c)(4)(ii)(D) for a similar rule in the context of section 704.

(E) *Identical Ownership or De Minimis Change In Ownership*. For purposes of section 737(b) and this section, net precontribution gain does not include new section 704(c) gain in property transferred by the transferor partnership to the transferee partnership if both the transferor partnership and the transferee partnership

are owned by the same owners in the same proportions or if the difference in ownership is *de minimis*. The transferor partnership and the transferee partnership are owned by the same owners in the same proportions if each partner owns identical interests in book capital and each item of income, gain, loss, deduction, and credit, and identical shares of distributions and liabilities in each of the transferor and transferee partnerships. A difference in ownership is *de minimis* if ninety seven percent of interests in book capital and each item of income, gain, loss, deduction and credit and shares in distributions and liabilities of the transferor partnership and transferee partnership are owned by the same owners in the same proportions. See §1.704–4(c)(4)(ii)(E) for a similar provision in the context of section 704.

(F) *Examples*. The following examples illustrate the rules of paragraph (b)(3) of this section.

Example (1). No net precontribution gain. (i) *Facts*. On January 1, 2005, A contributes Asset 1, with a basis of $200x and a fair market value of $300x, to partnership PRS1 in exchange for a 50 percent interest. On the same date, B contributes $300x of cash to PRS1 in exchange for a 50 percent interest. Also on January 1, 2005, C contributes Asset 2, with a basis of $100x and a fair market value of $200x, to partnership PRS2 in exchange for a 50 percent interest. D contributes $200x of cash to PRS2 in exchange for a 50 percent interest. On January 1, 2008, PRS1 and PRS2 undertake an assets-over partnership merger in which PRS1 is the continuing partnership and PRS2 is the terminating partnership for both state law and federal tax purposes. At the time of the merger, PRS1's only assets are Asset 1, with a fair market value of $900x, and $300x in cash. PRS2's only assets are Asset 2, with a fair market value of $600x and $200x in cash. After the merger, the partners have capital and profits interests in PRS1 as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. PRS1 and PRS2 both have provisions in their respective partnership agreements requiring the revaluation of partnership property upon entry of a new partner. PRS1 would not be treated as an investment company (within the meaning of section 351) if it were incorporated. Neither partnership holds any unrealized receivables or inventory for purposes of section 751. In addition, neither partnership has a section 754 election in place. Asset 1 and Asset 2 are nondepreciable capital assets. On January 1, 2013, PRS1 has the same assets that it had after the merger. Each asset has the same value that it had at the time of the merger. On this date, PRS1 distributes Asset 2 to A in liquidation of A's interest.

(ii) *Analysis*. Section 737(a) requires A to recognize gain when it receives a distribution of property in an amount equal to the lesser of the excess distribution or the partner's net precontribution gain. The distribution of Asset 2 to A results in an excess distribution of $400x ($600x fair market value of Asset 2 - $200x adjusted basis in A's partnership interest). However, the distribution of Asset 2 to A occurs more than seven years after the contribution by A of Asset 1 to PRS1 and A made no subsequent contributions to PRS1. Therefore, A's net precontribution gain for purposes of section 737(b) at the time of the distribution is zero. The $600x of reverse section 704(c) gain in Asset 1, resulting from a revaluation of PRS1's partnership property at the time of the merger, is not net precontribution gain (See §1.737–2(e)). Accordingly, A will not recognize gain under section 737 as a result of the distribution of Asset 2. See §1.704–4(c)(4)(ii)(F), *Example (1)* for a similar example under section 704.

Example (2). Revaluation gain and merger gain. (i) *Facts*. The facts are the same as *Example (1)*, except that on January 1, 2007, E joins PRS2 as a one-third partner for $250x in cash. At the time E joins the partnership, Asset 2 has a fair market value of $300x. On January 1, 2008, PRS2 merges into PRS1. At the time of the merger, Asset 1 and Asset 2 both have a fair market value of $400x. On January 1, 2011, Asset 1 is distributed to C when its value is $275x.

(ii) *Analysis*. Section 737(a) requires A to recognize gain when it receives a distribution of property in an amount equal to the lesser of the excess distribution or the partner's net precontribution gain. The distribution of Asset 1 to C results in an excess distribution of $175x ($275x fair market value of Asset 1 - $100x adjusted basis in C's partnership interest). The distribution of Asset 1 to C occurs within seven years of the original contribution of Asset 2 by C to PRS2. Therefore, C's net precontribution gain at the time of the distribution is $183.33x, which includes C's original section 704(c) gain from the contribution of Asset 2 to PRS2 of $100x plus C's share of new section 704(c) gain of $83.33x ($50x of reverse section 704(c) gain upon the admission of E, plus $33.33x of additional section 704(c) gain upon merger). C's excess distribution is less than C's net precontribution gain. Thus, C will recognize $175x of gain upon receipt of Asset 1 in accordance with section 737(a). See §1.704–4(c)(4)(ii)(F), *Example (2)* for a similar example under section 704.

Example (3). Fluctuations in the value of an asset. (i) *Facts*. The facts are the same as *Example (1)*, except that on January 1, 2011, Asset 1 is distributed to C when its fair market value is $300x. Immediately prior to the distribution, PRS1 revalues its property in accordance with §1.704–1(b)(2)(iv)(f).

(ii) *Analysis*. The distribution of Asset 1 to C occurs within seven years of the original contribution of Asset 2 by C to PRS2 and within seven years of the date of the merger. Therefore, C's net precontribution gain at the time of the distribution equals $300x ($100x of original section 704(c) gain from the contribution of Asset 2 to PRS2 and $200x of new section 704(c) gain). The distribution of Asset 1 to C results in an excess distribution of $200x ($300x fair market value of Asset 1 - $100x adjusted basis in C's partnership interest). Accordingly, in accordance with section 737(a), C will recognize gain of $200x upon receipt of Asset 1.

Example (4). Reverse section 704(c) gain. (i) *Facts*. The facts are the same as *Example (1)*, except that on January 1, 2011, PRS1 distributes Asset 2 to A in liquidation of A's interest in PRS1. At the time of the distribution, Asset 2 has a value of $600x.

(ii) *Analysis*. Section 737(a) requires A to recognize gain when it receives a distribution of property in an amount equal to the lesser of the excess distribution or the partner's net precontribution gain. The distribution of Asset 2 to A results in an excess distribution of $400x ($600x fair market value - 200x adjusted basis in A's partnership interest). The distribution of Asset 2 to A occurs within seven years after the contribution of Asset 1 to PRS1 by A. Thus, A's net precontribution gain for purposes of section 737(b) at the time of the distribution is $100x (A's original section 704(c) gain from the contribution of Asset 1 to PRS1). Under §1.737–2(e), A's net precontribution gain does not include A's reverse section 704(c) gain upon the revaluation of the Assets of PRS1 prior to the merger. Accordingly, A will recognize $100x of gain (the lesser of the excess distribution or net precontribution gain) under section 737 as a result of the distribution of Asset 2. See §1.704–4(c)(4)(ii)(F), *Example (4*) for a similar example under section 704.

Example (5). Identical ownership exception. (i) *Facts*. In 1990, A, an individual, and B, a subchapter C corporation, formed PRS1, a partnership. A owned 75 percent of the interests in the book capital, profits, losses, distributions, and liabilities of PRS1. B owned the remaining 25 percent interest in the book capital, profits, losses, distributions, and liabilities of PRS1. In the same year, A and B also formed another partnership, PRS2, with A owning 75 percent of the interests in PRS2 and B owning the remaining 25 percent. Upon formation of the partnerships, A contributed Asset X to PRS1 and Asset Y to PRS2 and B contributed cash. Both Assets X and Y had section 704(c) built-in gain at the time of contribution to the partnerships.

(ii) In January 2005, PRS1 is merged into PRS2 in an assets-over merger in which PRS1 is the terminating partnership and PRS2 as the continuing partnership for both state law and federal income tax purposes. At the time of the merger, both Assets X and Y had increased in value from the time they were contributed to PRS1 and PRS2, respectively. As a result, a new layer of section 704(c) gain was created with respect to Asset X in PRS1. After the merger, A had a 75 percent interest in PRS2's book capital, profits, losses, distributions, and liabilities. B held the remaining 25 percent interest in PRS2's book capital, profits, losses, distributions, and liabilities. In 2006, PRS2 distributes all of Asset X to A.

(iii) *Analysis*. The 2006 distribution by PRS2 occurs more than seven years after the formation of the partnerships and the original contribution of Asset X to the partnerships. Therefore, the original layer of built-in gain created on the original contribution of Asset X to the partnerships should not be taken into account in applying section 737 to the proposed liquidation. In addition, paragraph (b)(1)(ii)(E) of this section provides that section 737(a) does not apply to newly created section 704(c) gain in property transferred by the transferor partnership to the transferee partnership if both the transferor partnership and the transferee partnership are owned by the same owners in the same proportions. The transferor partnership and the transferee partnership are owned by the same owners in the same proportions if each partner's percentage interest in the transferor partnership's book capital, profits, losses, distributions, and liabilities is the same as the partner's percentage interest in those items of the transferee partnership. In this case, A

owned 75 percent and B owned 25 percent of the interests in the book capital, profits, losses, distributions, and liabilities of PRS1 and PRS2 prior to the merger and 75 percent and 25 percent, respectively, of PRS2 after the merger. As a result, the requirements of the identical ownership exception of paragraph (b)(1)(ii)(E) of this section are satisfied. Thus, the new built-in gain created upon contribution of Asset X in connection with the partnership merger will not be taken into account in applying section 737 to the proposed distribution. See §1.704–4(c)(4)(ii)(F), *Example (5)* for a similar example under section 704.

(2) *Certain divisive transactions*. (i) *In general*. Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of the section 704(c) property contributed by a partner to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the section 704(c) property to the transferor partnership (divisive transactions).

(ii) *Subsequent distributions*. After a divisive transaction referred to in paragraph (b)(2)(i) of this section, a subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to section 737 to the same extent that a distribution from the transferor partnership would have been subject to section 737.

* * * * *

(f) *Reverse section 704(c) gain*. For purposes of section 737(b), net precontribution gain does not include reverse section 704(c) gain as described in §1.704–3(a)(6)(i).

Par. 6. Section 1.737–5 is amended by revising the section heading and adding two additional sentences at the end of the paragraph to read as follows:

§1.737–5 *Effective applicability date*. * * * Section 1.737–1(c) is effective as of August 22, 2007. Section 1.737–2(b)(1) is effective for any distribution of property after January 19, 2005, if such property was contributed in a merger using the assets-over form after May 3, 2004.

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

(Filed by the Office of the Federal Register on August 21, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 22, 2007, 72 F.R. 46932)

Exclusions From Gross Income of Foreign Corporations; Correction

Announcement 2007–84

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final and temporary regulations.

SUMMARY: This document contains corrections to final and temporary regulations (T.D. 9332, 2007–32 I.R.B. 300) that were published in the **Federal Register** on Monday, June 25, 2007 (72 FR 34600) relating to the exclusion from gross income of income derived by certain foreign corporations engaged in the international operation of ships or aircraft.

DATES: The correction is effective August 13, 2007.

FOR FURTHER INFORMATION CONTACT: Patricia A. Bray, (202) 622–3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final and temporary regulations that are the subject of this correction are under section 883 of the Internal Revenue Code.

Need for Correction

As published, final and temporary regulations (T.D. 9332) contain errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the final and temporary regulations (T.D. 9332), which were the subject of FR Doc. E7–12039, is corrected as follows:

1. On page 34601, column 3, in the preamble, under the paragraph heading "*2. Elimination of Foreign Base Company Shipping Income*", line 3, the language "(118 Stat. 1418) (AJCA) repealed section" is corrected to read "(118 Stat. 1418)) (AJCA) repealed section".

2. On page 34602, column 3, in the preamble, under the paragraph heading "*C. Reporting requirements related to qualified shareholder stock ownership test*", last line, the language "at the office of that such practitioner." is corrected to read "at the office of that practitioner.".

3. On page 34603, column 1, in the preamble, under the paragraph heading "*2. Activities Incidental to the International Operation of Ships or Aircraft*", line 7 from the bottom of the paragraph, the language "to the international operation of a ship" is corrected to read "to the international operation of ships".

4. On page 34603, column 3, in the preamble, under the paragraph heading "*4. Countries that Provide an Exemption Through an Income Tax Convention and by Other Means*", lines 5 through 10, the language "exemption under section 883 through a diplomatic note, domestic statutory law, or by generally imposing no income tax on foreign corporations engaged in the international operation of ships or aircraft will continue to have the choice" is corrected to read "exemption under section 883 (through a diplomatic note, domestic statutory law, or because income tax is generally not imposed on foreign corporations engaged in the international operation of ships or aircraft) will continue to have the choice".

5. On page 34604, column 1, in the preamble, under the paragraph heading "*5. Reporting Requirements Related to Qualified Shareholder Stock Ownership Test*", first paragraph of the column, line 9, the language "addresses of shareholders in" is corrected to read "addresses of shareholders of".

6. On page 34604, column 2, in the preamble, under the paragraph heading "Effective Dates", line 1, the language "See § 1.883–5T(d) for effective date of" is corrected to read "See § 1.883–5T(d) for the effective date of".

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 August 10, 2007, 8:45 a.m., and published in the issue of the Federal Register for August 13, 2007, 72 F.R. 45159)

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

Announcement 2007–89

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

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

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on October 9, 2007, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Vietnam Chinese Mutual Aid
& Friendship Association
San Francisco, CA
Fairdale Athletic Club, Inc.
Louisville, KY
Good Schools For All
San Francisco, CA

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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