

## **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**

#### **T.D. 9384, page 792.**

Final regulations under section 199 of the Code revise certain rules and examples relating to the definitions of a qualified film produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) and an expanded affiliated group under section 199(d)(4).

#### **T.D. 9386, page 788.**

Final regulations under section 165 of the Code provide guidance on the availability and character of a deduction for a loss sustained from abandoned stock or other securities.

#### **T.D. 9387, page 789.**

Final regulations under section 168 of the Code provide guidance regarding the application of normalization accounting rules to balances of excess deferred income taxes and accumulated deferred investment tax credits of public utilities whose assets cease to be public utility property.

#### **REG-124590-07, page 801.**

Proposed regulations under section 954(d) of the Code provide guidance in cases in which personal property sold by a controlled foreign corporation is manufactured, produced, or constructed pursuant to a contract manufacturing arrangement or by one or more branches of the controlled foreign corporation.

#### **Notice 2008-44, page 799.**

**2007 section 45K inflation adjustment factor.** This notice announces the applicable inflation adjustment factor and phase-out amount for the nonconventional source fuel credit for the 2007 calendar year.

### **EMPLOYEE PLANS**

#### **REG-151135-07, page 815.**

Proposed regulations under section 432 of the Code provide additional rules for certain multiemployer defined benefit plans that are in effect on July 16, 2006. The regulations affect sponsors and administrators of, and participants in, multiemployer plans that are in either endangered or critical status. The regulations are necessary to implement the new rules set forth in section 432 that are effective for plan years beginning after 2007.

### **EXEMPT ORGANIZATIONS**

#### **Announcement 2008-32, page 826.**

The IRS has revoked its determination that Educate the Children Foundation of Long Beach, CA; CFIDS Walk-A-Thon Committee of Hicksville, NY; Open Doors, Inc., of Duluth, GA; Amalgamated Credit Counselors of Lauderhill, FL; Carter Lake Charitable of Urbandale, IA; Christian Credit Counselors, Inc., of Las Vegas, NV; In Time Youth Group of Ontario, OR; Young Lions Foundation of Sausalito, CA; Charity Connections, Ltd., of Pittsford, NY; and North-Tartan Area Girls Basketball Booster Club of Oakdale, MN, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

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Finding Lists begin on page ii.



# ESTATE TAX

## **Rev. Rul. 2008–22, page 796.**

**Substitution power.** This ruling provides guidance regarding whether the corpus of an *inter vivos* trust is includible in the grantor's gross estate under section 2036 or 2038 of the Code if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value. The ruling provides that, for estate tax purposes, the substitution power will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate, provided the trustee has a fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

# ADMINISTRATIVE

## **Announcement 2008–30, page 825.**

This document contains corrections to final and temporary regulations (T.D. 9368, 2008–6 I.R.B. 382) regarding the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Code. The regulations affect taxpayers claiming foreign tax credits and provide guidance needed to comply with the statutory changes made by the American Jobs Creation Act of 2004 (AJCA).

## **Announcement 2008–33, page 826.**

This document contains a correction to final regulations (T.D. 9273, 2006–2 C.B. 394) addressing the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in a corporate reorganization or liquidation that is described in both sections 367(b) and 381 of the Code.

## **Announcement 2008–36, page 827.**

This document cancels a public hearing on proposed regulations (REG–114126–07, 2008–6 I.R.B. 410) that provide guidance relating to the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Code.

# The IRS Mission

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

the tax law with integrity and fairness to all.

## Introduction

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

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

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

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

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

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

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

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

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

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

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

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

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

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

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

## Section 165.—Losses

26 CFR 1.165-5: *Worthless securities.*

### T.D. 9386

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

#### Abandonment of Stock or Other Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning the availability and character of a loss deduction under section 165 of the Internal Revenue Code (Code) for losses sustained from abandoned stock or other securities. The final regulations clarify the tax treatment of losses from abandoned securities, and affect any taxpayer claiming a deduction for a loss from abandoned securities after the date these regulations are published in the **Federal Register**.

DATES: *Effective Date:* These final regulations are effective on March 12, 2008.

*Applicability Date:* For dates of applicability, see §1.165-5(i)(2).

FOR FURTHER INFORMATION CONTACT: Sean M. Dwyer at (202) 622-5020 or Peter C. Meisel at (202) 622-7750 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

#### Background

This document contains amendments to 26 CFR part 1. On July 30, 2007, the IRS published a notice of proposed rulemaking (REG-101001-05, 2007-36 I.R.B. 548) in the **Federal Register** (72 FR 41468). The notice of proposed rulemaking clarified the treatment of abandoned stock or other securities under section 165 of the Code, specifically providing that a loss

from an abandoned security is governed by section 165(g), and that the loss is only allowed if all rights in the security are permanently surrendered and relinquished for no consideration. The IRS received no comments in response to the notice of proposed rulemaking. No public hearing was requested or held.

The proposed regulations are adopted as final regulations by this Treasury decision.

#### Special Analyses

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

#### Drafting Information

The principal authors of these final regulations are Sean M. Dwyer, Office of the Associate Chief Counsel (Income Tax & Accounting), and Peter C. Meisel, Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

#### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

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

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

Par. 2. Section 1.165-5 is amended by:

1. Redesignating paragraph (i) as paragraph (j).

2. Adding a new paragraph (i).

The addition reads as follows:

§1.165-5 *Worthless securities.*

\* \* \* \* \*

(i) *Abandonment of securities*—(1) *In general.* For purposes of section 165 and this section, a security that becomes wholly worthless includes a security described in paragraph (a) of this section that is abandoned and otherwise satisfies the requirements for a deductible loss under section 165. If the abandoned security is a capital asset and is not described in section 165(g)(3) and paragraph (d) of this section (concerning worthless securities of certain affiliated corporations), the resulting loss is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1) and paragraph (c) of this section. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. For purposes of this section, all the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.

(2) *Effective/applicability date.* This paragraph (i) applies to any abandonment of stock or other securities after March 12, 2008.

\* \* \* \* \*

Linda E. Stiff,  
*Deputy Commissioner for  
Services and Enforcement.*

Approved March 3, 2008.

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

(Filed by the Office of the Federal Register on March 11, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 12, 2008, 73 F.R. 13124)

## Section 168.—Accelerated Cost Recovery System

26 CFR 1.168(i)-3: Treatment of excess deferred income tax reserve upon disposition of deregulated public utility property.

### T.D. 9387

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

#### Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Assets Cease to be Public Utility Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

**SUMMARY:** This document contains final regulations that provide guidance on the normalization requirements applicable to public utilities that benefit (or have benefited) from accelerated depreciation methods or from the investment tax credit permitted under pre-1991 law. These regulations permit a utility whose assets cease, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the utility (deregulated public utility property) to return to its ratepayers the normalization reserve for excess deferred income taxes (EDFIT) with respect to those assets and, in certain circumstances, also permit the return of part or all of the reserve for accumulated deferred investment tax credits (ADITC) with respect to those assets.

**DATES:** *Effective Date:* These regulations are effective March 20, 2008.

*Applicability Date:* For dates of applicability, see §1.46-6(k)(4) and §1.168(i)-3(d) of these regulations.

FOR FURTHER INFORMATION CONTACT: Patrick Kirwan, at (202) 622-3040 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background and Explanation of Provisions

This document amends the Income Tax Regulations (26 CFR Part 1) relating to the normalization requirements of sections 168(f)(2) and 168(i)(9) of the Internal Revenue Code (Code), section 203(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2146), and former section 46(f) of the Code. Proposed regulations relating to the normalization requirements applicable to electric utilities that benefit (or have benefited) from accelerated depreciation methods or from the investment tax credit permitted under pre-1991 law (REG-104385-01, 2003-1 C.B. 634) were published in the **Federal Register** on March 4, 2003 (the 2003 proposed regulations) and again on December 21, 2005 (2006-1 C.B. 389, the 2005 proposed regulations). The preambles of both the 2003 proposed regulations and the 2005 proposed regulations describe the normalization method of accounting and the reserves under the normalization method for excess deferred federal income tax (EDFIT) and accumulated deferred investment tax credits (ADITC).

The 2003 proposed regulations provided that electric utilities whose generation assets become deregulated public utility property could continue to flow through EDFIT reserves associated with those assets without violating the normalization requirements. The rate of flowthrough was limited to the rate that would have been permitted under a normalization method of accounting if the assets had remained public utility property.

The 2003 proposed regulations provided similar rules under which electric utilities could continue to flow through ADITC reserves associated with generation assets that become deregulated public utility property without violating the normalization requirements. The 2003 proposed regulations addressed the treatment of these assets under former section 46(f)(2) (relating to the use of the investment credit to reduce the taxpayer's cost of service) but did not address their treatment under former section 46(f)(1) (relating to the use of the investment credit to reduce the taxpayer's rate base). The 2003 pro-

posed regulations would have applied to public utility generation property deregulated after March 4, 2003. Utilities would have been permitted an election to apply the proposed rules to generation property that was deregulated on or before that date.

In response to the public comments and after further analysis, the 2003 proposed regulations were withdrawn and were replaced by the 2005 proposed regulations. The 2005 proposed regulations generally retain the rule of the 2003 proposed regulations regarding the return of EDFIT reserves and extend the application of the rule to all public utility property.

The 2005 proposed regulations permit flowthrough of the ADITC reserve with respect to deregulated public utility property to continue after its deregulation only to the extent the reduction in cost of service does not exceed, as a percentage of the ADITC with respect to the property at the time of deregulation, the percentage of the total stranded cost that the taxpayer is permitted to recover with respect to the property. In addition, the 2005 proposed regulations provide that the credit may not be flowed through more rapidly than the rate at which the taxpayer is permitted to recover the stranded cost with respect to the property. The 2005 proposed regulations provide similar rules for property to which former section 46(f)(1) (relating to rate base restoration) applies and extend the application of the ADITC flowthrough rules to all public utility property.

The 2005 proposed regulations generally apply to any public utility property that becomes deregulated public utility property after December 21, 2005. They do not include an election to apply the regulations retroactively. For public utility property that became deregulated public utility property on or before December 21, 2005, the preamble of the 2005 proposed regulations states that the IRS will follow the holdings set forth in the private letter rulings prohibiting flowthrough of the EDFIT and ADITC reserves associated with an asset after the asset's disposition. The 2005 proposed regulations provide, however, that flowthrough will be permitted if it is consistent with the 2003 proposed regulations and occurs during the period beginning on March 5, 2003, and ending on the earlier of (1) the last date on which the utility's rates are determined under the

rate order in effect on December 21, 2005, or (2) December 21, 2007.

Written comments were received in response to the 2005 proposed regulations, and a public hearing was held on April 5, 2006. Three commentators spoke at the public hearing. After consideration of all the comments, the 2005 proposed regulations are adopted as amended by this Treasury decision. In general, the final regulations follow the approach of the 2005 proposed regulations.

A number of commentators suggested that the proposed rules should apply on an elective basis to public utility property that was deregulated prior to March 5, 2003, if regulatory proceedings for the deregulated public utility property are pending. The preamble to the 2005 proposed regulations explains that the Secretary's authority under section 7805(b)(7) to provide for retroactive elections should not be exercised in a manner that impairs existing agreements between utilities and their regulators. Many commentators agreed with the objective of not disturbing previously settled and finalized agreements and believed that a retroactive election would likely result in taxpayers being compelled to reopen such agreements. The commentators suggested, however, that applying the regulations to regulatory proceedings that have yet to be finally decided would not impair any existing agreement, and that the final regulations should permit continued flowthrough of the EDFIT and ADITC reserves if no final order or settlement agreement prescribing the treatment of those reserves after deregulation was in effect on December 21, 2005. Other commentators suggested that the section 7805 limitations on retroactivity do not apply to these regulations because the normalization provisions were enacted before the effective date of those limitations. The IRS and Treasury Department agree that there is no statutory impediment that would prohibit the application of the regulations to previously deregulated property. Nevertheless, the IRS and Treasury Department have concluded that there is no compelling argument in this instance for frustrating the expectations of taxpayers who embarked upon deregulation of their public utility property before the publication of the new rules. Accordingly, the final regulations do not depart from the general practice of applying amendments

to the regulations without retroactive effect and retain the prospective effective date of the 2005 proposed regulations without a retroactive election. The final regulations retain the proposed transition rule under which flowthrough is permitted if it is consistent with the 2003 proposed regulations and occurs during the period beginning on March 5, 2003, and ending on the earlier of (1) the last date on which the utility's rates are determined under the rate order in effect on December 21, 2005, or (2) December 21, 2007.

One commentator suggested that the regulations should provide guidance concerning when deregulation occurs. Under the regulations, property becomes deregulated public utility property when it ceases to be public utility property with respect to the taxpayer. This depends on the particular facts and circumstances and is more appropriately addressed on a case-by-case basis.

Some commentators suggested that the final regulations should permit flowthrough of ADITC reserves even in cases in which ratepayers do not bear the cost of the asset giving rise to the credit. The comments generally argued that this would be consistent with Congressional intent to share the benefit of the credit between ratepayers and shareholders. The IRS and Treasury Department agree that the Code provides for such sharing in the typical situation in which ratepayers ultimately bear the full cost of an asset through ratemaking depreciation. On the other hand, neither the statutory provision nor the legislative history provides any indication that Congress intended for ratepayers to share in benefits attributable to costs that they do not bear. Accordingly, for the reasons set forth in the preamble of the 2005 proposed regulations, the final regulations retain the proposed rules relating to flowthrough of the ADITC reserve and rate base restoration, including the rule allowing flowthrough consistent with the 2003 proposed regulations during the transition period.

Commentators suggested that the use of terms other than deregulated public utility property in the preamble of the 2005 proposed regulations implies that a distinction exists between property that ceases to be public utility property because of deregulation and property that ceases to be public utility property because of a disposition or other event. To clarify that this is not

the case, the term deregulated public utility property is the sole term used in the final regulations to describe property that ceases to be public utility property.

One commentator questioned whether the term deregulated public utility property includes normal retirements. The final regulations clarify that they do not apply to ordinary retirements within the meaning of section 1.167(a)-11(d)(3)(ii).

One commentator suggested that deregulated public utility property should include property that is public utility property in the hands of a transferee. The commentator further suggested that if the transferee of public utility property will continue the flowthrough of the transferor's EDFIT and ADITC reserves, further flowthrough by the transferor should not be required. The IRS and Treasury Department agree with these suggestions. Accordingly, the final regulations provide, on a prospective basis, that they apply to a taxpayer with respect to public utility property that ceases to be public utility property with respect to the taxpayer. Thus, the regulations will apply even if the property remains regulated public utility property in the hands of a transferee. The regulations further provide an exception from the generally applicable rule permitting transferor flowthrough when the transferee will continue flowthrough of the EDFIT reserves. A similar exception was not provided for the ADITC reserve because transferor flowthrough of that reserve does not occur if the transferee, rather than the transferor, is recovering the cost of the property through ratemaking depreciation.

## Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preced-

ing these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

### Drafting Information

The principal author of the regulations is Patrick S. Kirwan, Office of Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

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### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

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

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

Par. 2. Section 1.46-6 is amended by adding paragraph (k) to read as follows:

*§1.46-6 Limitation in case of certain regulated companies.*

\* \* \* \* \*

(k) *Treatment of accumulated deferred investment tax credits upon the deregulation of public utility property*—(1) *Scope*—(i) *In general.* This paragraph (k) provides rules for the application of former sections 46(f)(1) and 46(f)(2) of the Internal Revenue Code to a taxpayer with respect to public utility property that ceases, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the taxpayer and that is not described in paragraph (k)(1)(ii) of this section (deregulated public utility property).

(ii) *Exception.* This paragraph (k) does not apply to property that ceases to be public utility property with respect to the taxpayer on account of an ordinary retirement within the meaning of §1.167(a)-11(d)(3)(ii).

(2) *Ratable amount*—(i) *Restoration of rate base reduction.* A reduction in the taxpayer's rate base on account of the credit with respect to public utility property that becomes deregulated public

utility property is restored ratably during the period after the property becomes deregulated public utility property if the amount of the reduction remaining to be restored does not, at any time during the period, exceed the restoration percentage of the recoverable stranded cost of the property at such time.

For this purpose—

(A) The stranded cost of the property is the cost of the property reduced by the amount of such cost that the taxpayer has recovered through regulated depreciation expense during the period before the property becomes deregulated public utility property;

(B) The recoverable stranded cost of the property at any time is the stranded cost of the property that the taxpayer will be permitted to recover through rates after such time; and

(C) The restoration percentage for the property is determined by dividing the reduction in rate base remaining to be restored with respect to the property immediately before the property becomes deregulated public utility property by the stranded cost of the property.

(ii) *Cost of service reduction.* Reductions in the taxpayer's cost of service on account of the credit with respect to public utility property that becomes deregulated public utility property are ratable during the period after the property becomes deregulated public utility property if the cumulative amount of the reduction during such period does not, at any time during the period, exceed the flowthrough percentage of the cumulative stranded cost recovery for the property at such time.

For this purpose—

(A) The stranded cost of the property is the cost of the property reduced by the amount of such cost that the taxpayer has recovered through regulated depreciation expense during the period before the property becomes deregulated public utility property;

(B) The cumulative stranded cost recovery for the property at any time is the stranded cost of the property that the taxpayer has been permitted to recover through rates on or before such time; and

(C) The flowthrough percentage for the property is determined by dividing the amount of credit with respect to the property remaining to be used to reduce cost of service immediately before the property

becomes deregulated public utility property by the stranded cost of the property.

(3) *Cross reference.* See §1.168(i)-3 for rules relating to the treatment of balances of excess deferred income taxes when public utility property becomes deregulated public utility property.

(4) *Effective/applicability dates*—(i) *In general.* Except as provided in paragraph (k)(4)(ii) of this section, this paragraph (k) applies to public utility property that becomes deregulated public utility property with respect to a taxpayer after December 21, 2005.

(ii) *Property that becomes public utility property of the transferee.* This paragraph (k) does not apply to property that becomes deregulated public utility property with respect to a taxpayer on account of a transfer on or before March 20, 2008, if after the transfer the property is public utility property of the transferee.

(iii) *Application of regulation project (REG-104385-01).* A reduction in the taxpayer's cost of service will be treated as ratable if it is consistent with the proposed rules in regulation project (REG-104385-01) (68 FR 10190) March 4, 2003, and occurs during the period beginning on March 5, 2003, and ending on the earlier of—

(A) The last date on which the utility's rates are determined under the rate order in effect on December 21, 2005; or

(B) December 21, 2007.

Par. 3. Section 1.168(i)-3 is added to read as follows:

*§1.168(i)-3 Treatment of excess deferred income tax reserve upon disposition of deregulated public utility property.*

(a) *Scope*—(1) *In general.* This section provides rules for the application of section 203(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2146) to a taxpayer with respect to public utility property (within the meaning of section 168(i)(10)) that ceases, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the taxpayer and that is not described in paragraph (a)(2) of this section (deregulated public utility property).

(2) *Exceptions.* This section does not apply to the following property:

(i) Property that ceases to be public utility property with respect to the taxpayer on



account of an ordinary retirement within the meaning of §1.167(a)–11(d)(3)(ii).

(ii) Property transferred by the taxpayer if after the transfer the property is public utility property of the transferee and the taxpayer's excess tax reserve with respect to the property (within the meaning of section 203(e) of the Tax Reform Act of 1986) is treated as an excess tax reserve of the transferee with respect to the property.

(b) *Amount of reduction.* If public utility property of a taxpayer becomes deregulated public utility property to which this section applies, the reduction in the taxpayer's excess tax reserve permitted under section 203(e) of the Tax Reform Act of 1986 is equal to the amount by which the reserve could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued use of its normalization method of accounting with respect to such property.

(c) *Cross reference.* See §1.46–6(k) for rules relating to the treatment of accumulated deferred investment tax credits when utilities dispose of regulated public utility property.

(d) *Effective/applicability dates—(1) In general.* Except as provided in paragraph (d)(2) of this section, this section applies to public utility property that becomes deregulated public utility property after December 21, 2005.

(2) *Property that becomes public utility property of the transferee.* This section does not apply to property that becomes deregulated public utility property with respect to a taxpayer on account of a transfer on or before March 20, 2008, if after the transfer the property is public utility property of the transferee.

(3) *Application of regulation project (REG–104385–01).* A reduction in the taxpayer's excess deferred income tax reserve will be treated as ratable if it is consistent with the proposed rules in regulation project (REG–104385–01) (68 FR 10190) March 4, 2003, and occurs during the period beginning on March 5, 2003, and ending on the earlier of—

(i) The last date on which the utility's rates are determined under the rate order in effect on December 21, 2005; or

(ii) December 21, 2007.

Linda E. Stiff,  
*Acting Deputy Commissioner for  
Services and Enforcement.*

Approved March 6, 2008.

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

(Filed by the Office of the Federal Register on March 19, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 20, 2008, 73 F.R. 14934)

## Section 199.—Income Attributable to Domestic Production Activities

26 CFR 1.199–3: Domestic production gross receipts.

### T.D. 9384

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

### Qualified Films Under Section 199

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

**SUMMARY:** This document contains final regulations involving the deduction for income attributable to domestic production activities under section 199. The final regulations revise certain rules and examples relating to the definitions of a qualified film produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) and an expanded affiliated group under section 199(d)(4). The final regulations affect taxpayers who produce qualified films and taxpayers who are members of expanded affiliated groups.

**DATES:** *Effective Date:* These regulations are effective March 7, 2008.

*Applicability Date:* For dates of applicability, see §1.199–8(i)(8) and (9).

**FOR FURTHER INFORMATION CONTACT:** Concerning §1.199–3(k), David McDonnell, at (202) 622–3040;

concerning §1.199–7, Ken Cohen (202) 622–7790 (not toll-free numbers).

### SUPPLEMENTARY INFORMATION:

#### Background

This document amends §§1.199–3(k) and 1.199–7 of the Income Tax Regulations (26 CFR Part 1). Section 1.199–3(k) relates to the definition of qualified film produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) of the Internal Revenue Code (Code) and §1.199–7 involves expanded affiliated groups under section 199(d)(4). Section 199 was added to the Code by section 102 of the American Jobs Creation Act of 2004 (Public Law 108–357, 118 Stat. 1418), and amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Public Law 109–135, 119 Stat. 25), section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109–222, 120 Stat. 345), and section 401 of the Tax Relief and Health Care Act of 2006 (Public Law 109–432, 120 Stat. 2922).

On June 7, 2007, the IRS and Treasury Department published proposed regulations under section 199 (REG–103842–07, 2007–28 I.R.B. 79 [72 FR 31478]). The proposed regulations revise certain rules and examples in T.D. 9263, 2006–25 I.R.B. 1063 [71 FR 31268] relating to qualified films produced by the taxpayer under section 199(c)(4)(A)(i)(II) and (c)(6) and expanded affiliated groups under section 199(d)(4). No comments were received responding to the notice of proposed rulemaking and no public hearing was requested or held. Therefore, the proposed regulations are adopted without change by this Treasury decision.

#### Explanation of Provisions

##### General Overview

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income).

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) the taxpayer's domestic production gross receipts (DPGR) for such taxable year, over (B) the sum of (i) the cost of goods sold (CGS) that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under section 199) that are properly allocable to such receipts.

Section 199(c)(4)(A)(i) provides that the term DPGR means the taxpayer's gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of (I) qualifying production property (QPP) that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States; (II) any qualified film produced by the taxpayer; or (III) electricity, natural gas, or potable water produced by the taxpayer in the United States.

Section 199(c)(6) defines a qualified film to mean any property described in section 168(f)(3) if not less than 50 percent of the total compensation relating to production of the property is compensation for services performed in the United States by actors, production personnel, directors, and producers. The term does not include property with respect to which records are required to be maintained under 18 U.S.C. 2257 (generally, films, videotapes, or other matter that depict actual sexually explicit conduct and are produced in whole or in part with materials that have been mailed or shipped in interstate or foreign commerce, or are shipped or transported or are intended for shipment or transportation in interstate or foreign commerce).

Section 199(d)(4)(A) provides that all members of an expanded affiliated group (EAG) are treated as a single corporation for purposes of section 199. Under section 199(d)(4)(B), an EAG is an affiliated group as defined in section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to section 1504(b)(2) and (4).

#### *Qualified Film Produced by the Taxpayer*

Under section 199(c)(4)(A)(i)(II), a taxpayer's gross receipts qualify as DPGR if the receipts are derived from any lease, rental, license, sale, exchange, or other disposition of any qualified film (as de-

finied in section 199(c)(6)) produced by the taxpayer. A film must be both a "qualified film" under section 199(c)(6) and "produced by the taxpayer" under section 199(c)(4)(A)(i)(II) in order for the gross receipts to qualify as DPGR. However, as discussed in the preamble to the proposed regulations published on June 7, 2007 (72 FR 31478), the "by the taxpayer" compensation fraction in §1.199-3(k)(5) in T.D. 9263 (71 FR 31268) may have resulted in a film that was produced entirely within the United States as not qualifying under section 199(c)(6) if less than 50 percent of the total compensation relating to production was paid "by the taxpayer."

This Treasury decision revises the "by the taxpayer" compensation fraction in §1.199-3(k)(5) in T.D. 9263 (71 FR 31268) for determining the not-less-than-50-percent-of-the-total-compensation requirement under §1.199-3(k)(1). Under the revised fraction in §1.199-3(k)(5), the numerator of the revised fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. The revised fraction essentially compares (in the numerator) the sum of the compensation for services paid by the taxpayer for services performed in the United States and the compensation for services paid by others for services performed in the United States to (in the denominator) the sum of the total compensation for services paid by the taxpayer for services and the total compensation for services paid by others for services regardless of location.

Under §1.199-3(k)(6), a film that is a qualified film under §1.199-3(k)(1) will be treated as "produced by the taxpayer" for purposes of section 199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of §1.199-3(g)(2). Thus, a qualified film will be treated as produced by the taxpayer if the production of the qualified film by the taxpayer is substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's production activity, the nature of the qualified film, and the nature of the production activity that the taxpayer performs.

The revised fraction in §1.199-3(k)(5) follows the statutory language in section 199(c)(6) by referencing all compensation for services related to the production as opposed to the more limited "by the taxpayer" compensation fraction in T.D. 9263 (71 FR 31268). Because taxpayers may have difficulty obtaining information related to the compensation paid by others, this Treasury decision provides a safe harbor in §1.199-3(k)(7) that treats a film as a qualified film if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States. The safe harbor further provides that a qualified film will be treated as produced by the taxpayer if the taxpayer satisfies the safe harbor in §1.199-3(g)(3) with respect to the qualified film, which requires that the direct labor and overhead costs incurred by the taxpayer to produce the qualified film within the United States account for 20 percent or more of the total costs of the film. Thus, a taxpayer will be treated as having produced a qualified film if, in connection with the qualified film, the direct labor and overhead of the taxpayer to produce the qualified film within the United States account for 20 percent or more of the taxpayer's CGS of the qualified film, or in a transaction without CGS (for example, a lease, rental, or license) account for 20 percent or more of the taxpayer's "unadjusted depreciable basis" (as defined in §1.199-3(g)(3)(ii)) in the qualified film.

#### *Expanded Affiliated Groups*

As discussed in the preamble to the proposed regulations published on June 7, 2007 (72 FR 31478), §1.199-7(e), *Example 10*, in T.D. 9263 (71 FR 31268) misapplies §1.1502-13 of the consolidated return regulations. Accordingly, §1.199-7(e), *Example 10*, has been revised to correctly apply the consolidated return regulations. In addition, as also discussed in the preamble to the proposed regulations published on June 7, 2007 (72 FR 31478), the section 199 closing of the books method under §1.199-7(f)(1)(ii) in T.D. 9263 (71 FR 31268) could have created a larger section 199 deduction than is warranted. Accordingly, this Treasury decision removes the section 199 closing of the books method and revises the *Ex-*

ample in §1.199-7(g)(3) to apply the *pro rata* allocation method.

### Effective/Applicability Dates

Sections 1.199-3(k) and 1.199-7(e), *Example 10*, (f)(1), and (g)(3) are applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §§1.199-3(k) and 1.199-7(e), *Example 10*, to taxable years beginning after December 31, 2004, and before March 7, 2008. However, for taxable years beginning before June 1, 2006, a taxpayer may rely on §1.199-3(k) only if the taxpayer does not apply Notice 2005-14, 2005-1 C.B. 498 (see §601.601(d)(2)(ii)(b)), or REG-105847-05, 2005-2 C.B. 987 (see §601.601(d)(2)(ii)(b)), to the taxable year.

### Special Analyses

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

### Drafting Information

The principal author of these regulations is David H. McDonnell, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

## PART 1—INCOME TAXES

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

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

Par. 2. Section 1.199-0 is amended by:

1. Revising the entries for §1.199-3(k)(6) and (7).

2. Adding new entries for §§1.199-3(k)(7)(i) and (ii); (8), (9), and (10); and 1.199-8(i)(8) and (9).

3. Removing the entries for §1.199-7(f)(1)(i), (ii), and (iii).

The additions and revisions read as follows:

### §1.199-0 Table of contents.

\* \* \* \* \*

### §1.199-3 Domestic production gross receipts.

\* \* \* \* \*

(k) \* \* \*

(6) Produced by the taxpayer.

(7) Qualified film produced by the taxpayer — safe harbor.

(i) Safe harbor.

(ii) Determination of 50 percent.

(8) Production pursuant to a contract.

(9) Exception.

(10) Examples.

\* \* \* \* \*

### §1.199-8 Other rules.

\* \* \* \* \*

(i) \* \* \*

(8) Qualified film produced by the taxpayer.

(9) Expanded affiliated groups.

\* \* \* \* \*

Par. 3. Section 1.199-3 is amended by:

1. Revising paragraphs (k)(1), (k)(4), and (k)(5).

2. Redesignating paragraph (k)(6) as (k)(9).

3. Redesignating paragraph (k)(7) as (k)(10).

4. Adding new paragraphs (k)(6), (k)(7), and (k)(8).

5. Revising *Example 6* of newly redesignated paragraph (k)(10).

The revisions and additions read as follows:

### §1.199-3 Domestic production gross receipts.

\* \* \* \* \*

(k) *Definition of qualified film*—(1) *In general*. The term *qualified film* means any motion picture film or video tape under section 168(f)(3), or live or delayed television programming (film), if not less than 50 percent of the total compensation relating to the production of such film is compensation for services performed in the United States by actors, production personnel, directors, and producers. For purposes of this paragraph (k), the term *actors* includes players, newscasters, or any other persons who are compensated for their performance or appearance in a film. For purposes of this paragraph (k), the term *production personnel* includes writers, choreographers and composers who are compensated for providing services during the production of a film, as well as casting agents, camera operators, set designers, lighting technicians, make-up artists, and other persons who are compensated for providing services that are directly related to the production of the film. Except as provided in paragraph (k)(2) of this section, the definition of a qualified film does not include tangible personal property embodying the qualified film, such as DVDs or videocassettes.

\* \* \* \* \*

(4) *Compensation for services*. For purposes of this paragraph (k), the term *compensation for services* means all payments for services performed by actors, production personnel, directors, and producers relating to the production of the film, including participations and residuals. Payments for services include all elements of compensation as provided for in §1.263A-1(e)(2)(i)(B) and (3)(ii)(D). Compensation for services is not limited to W-2 wages and includes compensation paid to independent contractors. In the case of a taxpayer that uses the income forecast method of section 167(g) and capitalizes participations and residuals into the adjusted basis of the qualified film, the taxpayer must use the same estimate of participations and residuals in determining compensation for services. In the case of a taxpayer that excludes participations and residuals from the adjusted basis of the qualified film under section 167(g)(7)(D)(i), the taxpayer must use

the amount expected to be paid as participations and residuals based on the total forecasted income used in determining income forecast depreciation in determining compensation for services.

(5) *Determination of 50 percent.* The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is calculated using a fraction. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services performed in the United States and the total compensation for services regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

(6) *Produced by the taxpayer.* A qualified film will be treated as produced by the taxpayer for purposes of section 199(c)(4)(A)(i)(II) if the production activity performed by the taxpayer is substantial in nature within the meaning of paragraph (g)(2) of this section. The special rules of paragraph (g)(4) of this section regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer's production activity is substantial in nature. Paragraphs (g)(2) and (4) of this section are applied by substituting the term *qualified film* for QPP and disregarding the requirement that the production activity must be within the United States. The production activity of the taxpayer must consist of more than the minor or immaterial combination or assembly of two or more components of a film. For purposes of paragraph (g)(2) of this section, the relative value added by affixing trademarks or trade names as defined in §1.197-2(b)(10)(i) will be treated as zero.

(7) *Qualified film produced by the taxpayer — safe harbor.* A film will be treated as a qualified film under paragraph (k)(1) of this section and produced by the taxpayer under paragraph (k)(6) of this

section (qualified film produced by the taxpayer) if the taxpayer meets the requirements of paragraphs (k)(7)(i) and (ii) of this section. A taxpayer that chooses to use this safe harbor must apply all the provisions of this paragraph (k)(7).

(i) *Safe harbor.* A film will be treated as a qualified film produced by the taxpayer if not less than 50 percent of the total compensation for services paid by the taxpayer is compensation for services performed in the United States and the taxpayer satisfies the safe harbor in paragraph (g)(3) of this section. The special rules of paragraph (g)(4) of this section regarding a contract with an unrelated person and aggregation apply in determining whether the taxpayer satisfies paragraph (g)(3) of this section. Paragraphs (g)(3) and (4) of this section are applied by substituting the term *qualified film* for QPP but not disregarding the requirement that the direct labor and overhead of the taxpayer to produce the qualified film must be within the United States. Paragraph (g)(3)(ii)(A) of this section includes any election under section 181.

(ii) *Determination of 50 percent.* The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(7)(i) of this section is calculated using a fraction. The numerator of the fraction is the compensation for services paid by the taxpayer for services performed in the United States and the denominator is the total compensation for services paid by the taxpayer regardless of where the production activities are performed. For purposes of this paragraph (k)(7)(ii), the term *paid by the taxpayer* includes amounts that are treated as paid by the taxpayer under paragraph (g)(4) of this section. A taxpayer may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, including all historic information available, to determine the compensation for services paid by the taxpayer for services performed in the United States and the total compensation for services paid by the taxpayer regardless of where the production activities are performed. Among the factors to be considered in determining whether a taxpayer's method of allocating compensation is reasonable is whether the taxpayer uses that method consistently from one taxable year to another.

(8) *Production pursuant to a contract.* With the exception of the rules applicable to an expanded affiliated group (EAG) under §1.199-7 and EAG partnerships under §1.199-3(i)(8), only one taxpayer may claim the deduction under §1.199-1(a) with respect to any activity related to the production of a qualified film performed in connection with the same qualified film. If one taxpayer performs a production activity pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the qualified film under Federal income tax principles during the period in which the production activity occurs is treated as engaging in the production activity.

\* \* \* \* \*

(10) \* \* \*

*Example 6.* X creates a television program in the United States that includes scenes from films licensed by X from unrelated persons Y and Z. Assume that Y and Z produced the films licensed by X. The not-less-than-50-percent-of-the-total-compensation requirement under paragraph (k)(1) of this section is determined by reference to all compensation for services paid in the production of the television program, including the films licensed by X from Y and Z, and is calculated using a fraction as described in paragraph (k)(5) of this section. The numerator of the fraction is the compensation for services performed in the United States and the denominator is the total compensation for services regardless of where the production activities are performed. However, for purposes of calculating the denominator, in determining the total compensation paid by Y and Z, X need only include the total compensation paid by Y and Z to actors, production personnel, directors, and producers for the production of the scenes used by X in creating its television program.

\* \* \* \* \*

Par. 4. Section 1.199-7 is amended by:

1. Revising *Example 10* of paragraph (e).
2. Revising paragraphs (f)(1) and (g)(3).

The revisions read as follows:

*§1.199-7 Expanded affiliated groups.*

\* \* \* \* \*

(e) \* \* \*

*Example 10.* (i) *Facts.* Corporation P owns all of the stock of Corporations S and B. P, S, and B file a consolidated Federal income tax return on a calendar year basis. P, S, and B each uses the section 861 method for allocating and apportioning their deductions. In 2010, S MPGE QPP in the United States at a cost of \$1,000. On November 30, 2010, S sells the QPP to B for \$2,500. On February 28, 2011, P sells 60% of the stock of B to X, an unrelated person. On June 30, 2011, B sells the QPP to U, another unrelated person, for \$3,000.

(ii) *Consolidated group's 2010 QPAI.* Because S and B are members of a consolidated group in 2010, pursuant to §1.199-7(d)(1) and §1.1502-13, neither S's \$1,500 of gain on the sale of QPP to B nor S's \$2,500 gross receipts from the sale are taken into account in 2010. Accordingly, neither S nor B has QPAI in 2010.

(iii) *Consolidated group's 2011 QPAI.* B becomes a nonmember of the consolidated group at the end of the day on February 28, 2011, the date on which P sells 60% of the B stock to X. Under §1.199-7(d)(1) and §1.1502-13(d), S takes the intercompany transaction into account immediately before B becomes a nonmember of the consolidated group. Pursuant to §1.1502-13(d)(1)(ii)(A)(I), because the QPP is owned by B, a nonmember of the consolidated group immediately after S's gain is taken into account, B is treated as selling the QPP to a nonmember for \$2,500, B's adjusted basis in the property, immediately before B becomes a nonmember of the consolidated group. Accordingly, immediately before B becomes a nonmember of the consolidated group, S takes into account \$1,500 of QPAI (S's \$2,500 DPGR received from B - S's \$1,000 cost of MPGE the QPP).

(iv) *B's 2011 QPAI.* Pursuant to §1.1502-13(d)(2)(i)(B), the attributes of B's corresponding item, that is, its sale of the QPP to U, are determined as if the S division (but not the B division) were transferred by the P, S, and B consolidated group (treated as a single corporation) to an unrelated person. Thus, S's activities in MPGE the QPP before the intercompany sale of the QPP to B continue to affect the attributes of B's sale of the QPP. As such, B is treated as having MPGE the QPP. Accordingly, upon its sale of the QPP, B has \$500 of QPAI (B's \$3,000 DPGR received from U minus B's \$2,500 cost of MPGE the QPP).

\* \* \* \* \*

(f) *Allocation of income and loss by a corporation that is a member of the expanded affiliated group for only a portion of the year—(1) In general.* A corporation that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the taxable year that it is a member of the EAG and the portion of the taxable year that it is not a member of the EAG. This allocation of items is made by using the *pro rata* allocation method described in this paragraph (f)(1). Under the *pro rata* allocation method, an equal portion of a corporation's taxable income or loss, QPAI, and W-2 wages for the taxable year is assigned to each day of the corporation's taxable year. Those items assigned to those days that the corporation was a member of the EAG are then aggregated.

\* \* \* \* \*

(g) \* \* \*

(3) *Example.* The following example illustrates the application of paragraphs (f) and (g) of this section:

*Example. (i) Facts.* Corporations X and Y, calendar year corporations, are members of the same EAG for the entire 2010 taxable year. Corporation Z, also a calendar year corporation, is a member of the EAG of which X and Y are members for the first half of 2010 and not a member of any EAG for the second half of 2010. During the 2010 taxable year, neither X, Y, nor Z joins in the filing of a consolidated Federal income tax return. Assume that X, Y, and Z each has W-2 wages in excess of the section 199(b) wage limitation for all relevant periods. In 2010, X has taxable income of \$2,000 and QPAI of \$600, Y has a taxable loss of \$400 and QPAI of (\$200), and Z has taxable income of \$1,400 and QPAI of \$2,400.

(ii) *Analysis.* Pursuant to the *pro rata* allocation method, \$700 of Z's 2010 taxable income and \$1,200 of Z's 2010 QPAI are allocated to the first half of the 2010 taxable year (the period in which Z is a member of the EAG) and \$700 of Z's 2010 taxable income and \$1,200 of Z's 2010 QPAI are allocated to the second half of the 2010 taxable year (the period in which Z is not a member of any EAG). Accordingly, in 2010, the EAG has taxable income of \$2,300 (X's \$2,000 + Y's (\$400) + Z's \$700) and QPAI of \$1,600 (X's \$600 + Y's (\$200) + Z's \$1,200). The EAG's section 199 deduction for 2010 is therefore \$144 (9% of the lesser of the EAG's \$2,300 of taxable income or \$1,600 of QPAI). Pursuant to §1.199-7(c)(1), this \$144 deduction is allocated to X, Y, and Z in proportion to their respective QPAI. Accordingly, X is allocated \$48 of the EAG's section 199 deduction, Y is allocated \$0 of the EAG's section 199 deduction, and Z is allocated \$96 of the EAG's section 199 deduction. For the second half of 2010, Z has taxable income of \$700 and QPAI of \$1,200. Therefore, for the second half of 2010, Z has a section 199 deduction of \$63 (9% of the lesser of its \$700 taxable income or \$1,200 QPAI for the second half of 2010). Accordingly, X's 2010 section 199 deduction is \$48, Y's 2010 section 199 deduction is \$0, and Z's 2010 section 199 deduction is \$159, the sum of the \$96 section 199 deduction of the EAG allocated to Z for the first half of 2010 and Z's \$63 section 199 deduction for the second half of 2010.

\* \* \* \* \*

Par. 5. Section 1.199-8 is amended by:

1. Adding two sentences at the end of paragraph (a).

2. Adding new paragraphs (i)(8) and (i)(9).

The revisions and additions read as follows:

*§1.199-8 Other rules.*

(a) *In general.* \* \* \* For purposes of §§1.199-1 through 1.199-9, use of terms such as *payment*, *paid*, *incurred*, or *paid or incurred* is not intended to provide any specific rule based upon the use of one term versus another. In general, the use of the term *payment*, *paid*, *incurred*, or

*paid or incurred* is intended to convey the appropriate standard under the taxpayer's method of accounting.

\* \* \* \* \*

(i) \* \* \*

(8) *Qualified film produced by the taxpayer.* Section 1.199-3(k) is applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §1.199-3(k) to taxable years beginning after December 31, 2004, and before March 7, 2008. However, for taxable years beginning before June 1, 2006, a taxpayer may rely on §1.199-3(k) only if the taxpayer does not apply Notice 2005-14, 2005-1 C.B. 498 (see §601.601(d)(2)(ii)(b) of this chapter), or REG-105847-05, 2005-2 C.B. 987 (see §601.601(d)(2)(ii)(b) of this chapter), to the taxable year.

(9) *Expanded affiliated groups.* Section 1.199-7(e), *Example 10*, (f)(1), and (g)(3) are applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §1.199-7(e), *Example 10*, to taxable years beginning after December 31, 2004, and before March 7, 2008.

Linda E. Stiff,  
Deputy Commissioner for  
Services and Enforcement.

Approved March 3, 2008.

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

(Filed by the Office of the Federal Register on March 6, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 7, 2008, 73 F.R. 12268)

## Section 2036.—Transfers With Retained Life Estate

26 CFR 20.2036-1: *Transfers with retained life estate.*

(Also § 2038; 20.2038-1.)

**Substitution power.** This ruling provides guidance regarding whether the corpus of an *inter vivos* trust is includible in the grantor's gross estate under section 2036 or 2038 of the Code if the grantor retained the power, exercisable in a non-fiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value. The ruling provides that, for estate tax purposes, the substitution power will not, by itself, cause the value of the trust corpus to be includible

in the grantor's gross estate, provided the trustee has a fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

## Rev. Rul. 2008-22

### ISSUE

Is the corpus of an *inter vivos* trust includible in the grantor's gross estate under § 2036 or 2038 of the Internal Revenue Code if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value?

### FACTS

In Year 1, *D*, a United States citizen, established and funded Trust. Trust is an irrevocable *inter vivos* trust for the benefit of *D*'s descendants. *T* is the trustee of Trust, and *D* is prohibited from serving as trustee under the terms of Trust. The governing instrument provides that *D* has the power, exercisable at any time, to acquire any property held in Trust by substituting other property of equivalent value. The power is exercisable by *D* in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power of substitution, *D* must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. In addition, under local law, *T* has a fiduciary obligation to ensure that the properties being exchanged are of equivalent value. Under local law, if a trust has two or more beneficiaries, the trustee has a duty to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Further, under local law and without restriction in the trust instrument, *T* has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

*D* dies in Year 2.

### LAW AND ANALYSIS

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a *bona fide* sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before the decedent's death, (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from the property.

Section 2038(a)(1) provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a *bona fide* sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of the decedent's death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq. in result*, 1977-2 C.B. 1, the decedent created an *inter vivos* trust. Under the terms of the trust, the decedent reserved the power to substitute other securities or property for those held in trust, provided the substituted property was equal in value to the property replaced. After the decedent's death, the Service argued that the trust assets were includible in the decedent's gross estate under § 2038 because the decedent's power to substitute assets of equal value could be exercised to alter the beneficial interests in the trust. The court determined, however, that because the decedent was bound by fiduciary standards and was therefore accountable in equity to the succeeding income beneficiary and remaindermen, the decedent

could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries. Accordingly, the court held that the substitution power was not a power to alter, amend, or revoke the trust within the meaning of § 2038.

In general, a trustee has a fiduciary duty to the trust and its beneficiaries. As a result, the trustee is held to a high standard of conduct with respect to the administration of the trust. A trustee is under a duty to the beneficiaries of the trust to administer the trust solely in the interest of the beneficiaries. The trustee must act fairly, justly, honestly, in the utmost good faith, and with sound judgment and prudence. 90A C.J.S. Trusts § 323 (2007). The trustee is also subject to a duty of impartiality that requires the trustee to take into account the interests of all the beneficiaries for whom the trustee is acting. Restatement (Third) of Trusts §§ 183 and 232 (2007); 76 Am. Jur. 2d Trusts § 434 (2008). A trustee must administer the trust solely in the interests of the beneficiaries. Generally, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or which is otherwise affected by a conflict between the trustee's fiduciary and personal interests may be voidable by a beneficiary affected by the transaction. Uniform Trust Code § 802 (2005). If a trust has two or more beneficiaries, the trustee must act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests. Uniform Trust Code § 803 (2005). See also, *Sallee v. Fort Knox National Bank, et. al.*, 286 F.3d 878, 891 (6<sup>th</sup> Cir. 2002) (distinguishing between a duty of good faith and fair dealing, requiring parties to "deal fairly" with one another, and the more onerous fiduciary duty that requires a party to place the interest of the other party before one's own interests).

In situations where the grantor of a trust holds a nonfiduciary power to replace trust assets with assets of equivalent value, the trustee has a duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted. If the trustee knows or has reason to believe that the exercise of the substitution power does not satisfy the terms of the trust instrument because the assets being substituted have a lesser value than the

trust assets being replaced, the trustee has a fiduciary duty to prevent the exercise of the power. See Restatement (Third) of Trusts § 75 (2007) and Uniform Trust Code §§ 801 and 802 (2005).

In the instant case, unlike the situation presented in *Estate of Jordahl*, the trust instrument expressly prohibits *D* from serving as trustee and states that *D*'s power to substitute assets of equivalent value is held in a nonfiduciary capacity. Thus, *D* is not subject to the rigorous standards attendant to a power held in a fiduciary capacity. However, under the terms of the trust, the assets *D* transfers into the trust must be equivalent in value to the assets *D* receives in exchange. In addition, *T* has a fiduciary obligation to ensure that the assets exchanged are of equivalent value. Thus, *D* cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase *D*'s net worth. Further, in view of *T*'s ability to reinvest the assets and *T*'s duty of impartiality regarding the trust beneficiaries, *T* must prevent any shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by *D*. Under these circumstances, *D*'s retained power will not cause

the value of the trust corpus to be included in *D*'s gross estate under § 2036 or 2038.

#### HOLDING

A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the

respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Mayer Samuels of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Samuels at (202) 622-3090 (not a toll-free call).

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### Section 2038.—Revocable Transfers

26 CFR 20.2038-1: Revocable transfers.

Is the corpus of an *inter vivos* trust includible in the grantor's gross estate under section 2036 or 2038 of the Internal Revenue Code if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value. See Rev. Rul. 2008-22, page 796.

# Part III. Administrative, Procedural, and Miscellaneous

## Nonconventional Source Fuel Credit, Section 45K Inflation Adjustment Factor, and Section 45K Reference Price

### Notice 2008-44

#### SECTION 1. PURPOSE

This notice publishes the nonconventional source fuel credit, inflation adjustment factor, and reference price under § 45K of the Internal Revenue Code for calendar year 2007. These are used to determine the credit allowable under § 45K for fuel produced from a nonconventional source. The calendar year 2007 inflation-adjusted credit applies to the sales of barrel-of-oil equivalent of qualified fuels sold by a taxpayer to an unrelated person during the 2007 calendar year, the domestic production of which is attributable to the taxpayer.

#### SECTION 2. BACKGROUND

Section 45K(a) provides for a credit for producing fuel from a nonconventional source, measured in barrel-of-oil equivalent of qualified fuels, the production of which is attributable to the taxpayer and is sold by the taxpayer to an unrelated person during the tax year. The credit is equal to the product of \$3.00 and the appropriate inflation adjustment factor.

Section 45K(b)(1) and (2) provides for a phase-out of the credit. The credit allowable under § 45K(a) must be reduced by an amount which bears the same ratio to the amount of the credit (determined without regard to § 45K(b)(1)) as the amount by which the reference price for the calendar year in which the sale occurs exceeds \$23.50 bears to \$6.00. The \$3.00 in § 45K(a) and the \$23.50 and \$6.00 each must be adjusted by multiplying these amounts by the appropriate inflation adjustment factor.

Section 45K(c)(1), in part, defines the term “qualified fuels” to include gas produced from biomass and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.

Section 45K(d)(1) provides that the credit applies only to sales of qualified

fuels the production of which is within the United States (within the meaning of § 638(1)) or a possession of the United States (within the meaning of § 638(2)).

Section 45K(d)(2)(A) requires that the Secretary, not later than April 1 of each calendar year, determine and publish in the Federal Register the inflation adjustment factor and the reference price for the preceding calendar year.

Section 45K(d)(2)(B) defines “inflation adjustment factor” for a calendar year as a fraction the numerator of which is the GNP implicit price deflator for the calendar year and the denominator of which is the GNP implicit price deflator for calendar year 1979. The term “GNP implicit price deflator” means the first revision of the implicit price deflator for the gross national product as computed and published by the Department of Commerce.

Section 45K(d)(2)(C) defines “reference price” to mean with respect to a calendar year the Secretary’s estimate of the annual average wellhead price per barrel for all domestic crude oil the price of which is not subject to regulation by the United States.

Section 45K(d)(5) provides that the term “barrel-of-oil equivalent” with respect to any fuel generally means that amount of the fuel that has a Btu content of 5.8 million.

Section 45K(g)(1) provides that in the case of a facility for producing coke or coke gas, which was placed in service before January 1, 1993, or after June 30, 1998, and before January 1, 2010, § 45K(g) shall apply with respect to coke and coke gas produced in such facility and sold during the period beginning on the later of January 1, 2006, or the date that such facility is placed in service, and ending on the date which is 4 years after the date such period began.

Section 45K(g)(2)(B) provides that in determining the amount of credit allowable under § 45K solely by reason of § 45K(g), § 45K(d)(2)(B) shall be applied by substituting “2004” for “1979.” Accordingly, for purposes of § 45K(g), the inflation adjustment factor for a calendar year is a fraction the numerator of which is the GNP implicit price deflator for the calendar year and the denominator

of which is the GNP implicit price deflator for calendar year 2004.

Section 45K(g)(2)(D) provides that the phase-out of the credit under § 45K(b)(1) does not apply in the case of facilities producing coke or coke gas.

#### SECTION 3. REFERENCE PRICE

The reference price for calendar year 2007 is \$66.52.

#### SECTION 4. INFLATION ADJUSTMENT AND CREDIT AMOUNT

*.01 Gas Produced from Biomass and Liquid, Gaseous, or Solid Synthetic Fuel Produced from Coal.*

In the case of gas produced from biomass and liquid, gaseous, or solid synthetic fuel produced from coal, the inflation adjustment factor for calendar year 2007 is 2.4160. Because the calendar year 2007 reference price exceeds \$23.50 multiplied by the inflation adjustment factor, the credit per barrel equivalent of qualified fuel sold in calendar year 2007 is reduced by \$4.87, which is the amount that bears the same ratio to the amount of the credit (determined without regard to § 45K(b)(1)) as the amount by which the reference price for the calendar year 2007 exceeds \$23.50 (adjusted for inflation) bears to \$6.00 (adjusted for inflation).

The phase-out amount is computed as follows:

$$(\$3.00 \times 2.4160) \times [(\$66.52 - (\$23.50 \times 2.4160)) / (\$6.00 \times 2.4160)] = \$4.87.$$

The nonconventional source fuel credit under § 45K(a) is \$2.38 per barrel-of-oil equivalent of qualified fuels [\$(\\$3.00 \times 2.4160) - \\$4.87].

*.02 Facilities for Producing Coke or Coke Gas.* In case of facilities producing coke or coke gas, the inflation adjustment factor for calendar year 2007 is 1.0936. The nonconventional source fuel credit is \$3.28 per barrel-of-oil equivalent (\$3.00 x 1.0936).

#### SECTION 5. DRAFTING INFORMATION CONTACT

The principal author of this notice is Jennifer Bernardini of the Office of Associate Chief Counsel (Passthroughs



and Special Industries). For further information regarding this notice, contact Ms. Bernardini at (202) 622-3110 (not a toll-free call).

# Part IV. Items of General Interest

## Notice of Proposed Rulemaking

### Guidance Regarding Foreign Base Company Sales Income

#### REG-124590-07

AGENCY: Internal Revenue Service (IRS), Treasury Department.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance relating to foreign base company sales income, as defined in section 954(d), in cases in which personal property sold by a controlled foreign corporation (CFC) is manufactured, produced, or constructed pursuant to a contract manufacturing arrangement or by one or more branches of the CFC. These regulations, in general, will affect CFCs and their United States shareholders. Certain portions of these proposed regulations restate changes to §1.954-3(a)(4) that were contained in former proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by May 28, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-124590-07), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044 or send electronically, via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-124590-07).

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

#### SUPPLEMENTARY INFORMATION:

##### Background

##### A. Foreign Base Company Sales Income

Under section 951(a)(1)(A)(i), a United States shareholder of a CFC includes in

gross income its *pro rata* share of the CFC's subpart F income for the CFC's taxable year which ends with or within the taxable year of the shareholder. Section 952(a)(2) defines the term "subpart F income" to mean, in part, "foreign base company income." Section 954(a)(2) defines "foreign base company income" to include foreign base company sales income (FBCSI) for the taxable year. Section 954(d)(1) defines FBCSI to mean income derived by a CFC in connection with (1) the purchase of personal property from a related person and its sale to any person, (2) the sale of personal property to any person on behalf of a related person, (3) the purchase of personal property from any person and its sale to a related person, or (4) the purchase of personal property from any person on behalf of a related person, provided (in all of these cases) that the property both is manufactured, produced, grown or extracted outside of the CFC's country of organization and is sold for use, consumption or disposition outside of such country.

The Treasury regulations further define FBCSI and the applicable exceptions from FBCSI. These exceptions from FBCSI are contained in §1.954-3(a)(2), which addresses personal property manufactured, produced, constructed, grown, or extracted within the CFC's country of organization (the same country manufacture exception), §1.954-3(a)(3), which addresses personal property sold for use, consumption or disposition within the CFC's country of organization, and §1.954-3(a)(4) which addresses personal property manufactured, produced or constructed by the CFC (the manufacturing exception).

Section 1.954-3(a)(4)(i) provides that FBCSI does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. It then states generally that a foreign corporation is considered to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased. Specifically, §1.954-3(a)(4)(i) states that personal property sold will be considered

as not being the property purchased if the provisions of §1.954-3(a)(4)(ii) or (iii) are satisfied.

Section 1.954-3(a)(4)(ii) and (iii) set forth two separate tests to determine whether a CFC is considered to manufacture, produce, or construct personal property that it sells. First, §1.954-3(a)(4)(ii) sets forth a "substantial transformation" test, pursuant to which if personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation. Examples of substantial transformation provided in the regulations include the conversion of wood pulp to paper, steel rods to screws and bolts, and tuna fish to canned tuna. Second, §1.954-3(a)(4)(iii) sets forth a general "substantive test" and a safe harbor that apply when purchased property is used by the CFC as a component part of personal property that is sold by the CFC. Under the substantive test, the sale of personal property will be treated as the sale of a product manufactured by the CFC rather than the sale of component parts if the operations conducted by the CFC in connection with the property are substantial in nature and generally considered to constitute the manufacture, production, or construction of the property. The assembly of automobiles from component parts is provided as an example of an activity considered to be substantial in nature and generally considered to constitute the manufacture of a product. Under the safe harbor, without limiting the application of the substantive test, the operations of a selling corporation in connection with the use of purchased property as a component part of the personal property that is sold will be considered to constitute the manufacture of a product if in connection with such property conversion costs (direct labor and factory burden) of such corporation account for 20 percent or more of the total cost of goods sold. Section 1.954-3(a)(4)(iii) makes clear that, in no event, however, will packaging, prepackaging, labeling, or minor assembly operations constitute the manufacture, production, or construction of property for purposes of section 954(d)(1). For purposes of this preamble, satisfaction of

the requirements of §1.954-3(a)(4)(ii) or (iii) will be referred to as satisfaction of the “physical manufacturing test.”

### B. The Branch Rule

In addition to the general FBCSI rules of section 954(d)(1), section 954(d)(2) provides a special rule for purposes of determining FBCSI if a CFC carries on activities through a branch or similar establishment outside its country of organization and the carrying on of such activities has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation (the branch rule). Under the branch rule, to the extent prescribed by regulations, the income attributable to the carrying on of such activities is treated as income derived by a wholly owned subsidiary of the CFC and constitutes FBCSI of the CFC. See section 954(d)(2). Section 1.954-3(b)(1)(i) (addressing sales or purchase branches) and (ii) (addressing manufacturing branches) provide rules on the application of the branch rule. The purpose of the branch rule is to prevent a CFC from using a foreign branch to avoid the application of the FBCSI rules. Absent the branch rule, a CFC could engage in purchasing or manufacturing activities with respect to personal property in a high-tax jurisdiction and selling activities with respect to the property in a low-tax jurisdiction without incurring FBCSI. In such a case, the sales income would not be FBCSI to the CFC because the same person would be purchasing or manufacturing the personal property and selling the personal property. The branch rule therefore treats a sales, purchase, or manufacturing branch located outside of the country of organization of the CFC as a separate corporation so as to create a related party transaction between the branch and the remainder of the CFC for purposes of determining FBCSI.

With respect to manufacturing branches, §1.954-3(b)(1)(ii)(a) provides that if a CFC carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside of its country of organization and the use of that branch or similar establishment for such activities with respect to personal property purchased or sold by or

through the remainder of the CFC has substantially the same tax effect as if that branch or similar establishment were a wholly owned subsidiary corporation of such CFC, that branch or similar establishment and the remainder of the CFC will be treated as separate corporations for purposes of determining FBCSI of such CFC. Section 1.954-3(b)(1)(ii)(b) provides that the use of a manufacturing branch or similar establishment will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the CFC if the tax imposed on the income derived by the remainder of the CFC satisfies the test set forth in §1.954-3(b)(1)(ii)(b) (the manufacturing branch tax rate disparity test). There is also a separate tax rate disparity test which applies to sales or purchase branches under §1.954-3(b)(1)(i)(b) (the sales branch tax rate disparity test).

For purposes of the manufacturing branch tax rate disparity test, the income considered to be derived by the remainder of the CFC is determined first by applying the rules of §1.954-3(b)(2)(i) which treat the CFC and the manufacturing branch as separate corporations, and then by determining the income of the CFC that would be FBCSI under section 954(d)(1) and §1.954-3(a)(1) if the CFC and the branch were separate corporations (but without applying the exceptions contained in §1.954-3(a)(2), (3), and (4)).

Specifically, §1.954-3(b)(2)(i)(a) treats the remainder of the CFC and the manufacturing branch as separate corporations. In addition, §1.954-3(b)(2)(i)(b) and (c) deem purchases or sales to be made “on behalf of” a related person to take into account that the remainder of the CFC and the branch are treated as separate corporations. Section 1.954-3(b)(2)(i)(b) addresses sales and purchase branches by treating selling or purchasing activities conducted through a branch or similar establishment with respect to personal property as performed on behalf of the CFC if the CFC manufactures, produces, constructs, grows, extracts, purchases, or sells that same property. Section 1.954-3(b)(2)(i)(c) provides a corollary rule addressing manufacturing branches, pursuant to which the purchase or sale of personal property by the remainder of the CFC is treated as performed on behalf of a branch that manufactures, produces,

constructs, grows, or extracts that property. The general rule of §1.954-3(a)(1) is then applied to determine the income that would be FBCSI if the branch and the remainder of the CFC were separate corporations subject to the “on behalf of” related party transactions described above.

Section 1.954-3(b)(1)(ii)(b) provides that the manufacturing branch tax rate disparity test is satisfied if the income that would be FBCSI after applying these special rules is taxed in the year when earned at an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the hypothetical effective rate of tax. The hypothetical effective rate of tax is the effective rate of tax which would apply to such income under the laws of the country in which the manufacturing branch is located, if, under the laws of such country, the entire income of the CFC were considered derived by such CFC from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the CFC were created or organized under the laws of, and managed and controlled in, such country.

If the manufacturing branch tax rate disparity test is satisfied, §1.954-3(b)(1)(ii)(a) then treats the branch and the remainder of the CFC as separate corporations and the special rules of §1.954-3(b)(2)(ii) are applied for purposes of determining FBCSI. Section 1.954-3(b)(2)(ii)(a) through (c) provide separate CFC and related party rules that mirror §1.954-3(b)(2)(i)(a) through (c). Section 1.954-3(b)(2)(ii)(d) through (f) provide special rules to prevent double counting of FBCSI and to align treatment of branches with the treatment of separate CFCs. In particular, §1.954-3(b)(2)(ii)(e) provides that income derived by a branch or similar establishment, or by the remainder of the CFC, will not be FBCSI if the income would not be so considered if it were derived by a separate CFC under like circumstances.

### C. Legal Developments

In Rev. Rul. 75-7, 1975-1 C.B. 244, revoked by Rev. Rul. 97-48, 1997-2 C.B. 89, the IRS considered a case in which a CFC purchased raw material from related persons outside of its country of

organization, contracted with an unrelated manufacturer located outside of its country of organization to process the raw material into a finished product, and then sold the finished product to unrelated persons outside of its country of organization. Under the terms of the arrangement, the contract manufacturer was paid a conversion fee. The raw material, work in process, and finished product remained the property of the CFC at all times. The CFC alone had complete control over the time and quantity of production as well as complete quality control over the conversion process. The IRS ruled, under these facts, that the performance of the operations by the contract manufacturer whereby the raw material was processed into a finished good was considered to be a performance by the CFC, and the CFC would therefore be treated as having substantially transformed personal property. The ruling further concluded that, because the CFC conducted the manufacturing activity outside of its country of organization, it was considered to do so through a branch or similar establishment. Because the manufacturing branch tax rate disparity test was not satisfied, however, the activities of the “branch” were not treated as the activities of a separate CFC and the CFC was therefore entitled to the manufacturing exception from FBCSI. See §601.601(d)(2)(ii)(b).

In *Ashland Oil, Inc. v. Commissioner*, 95 TC 348 (1990), the Tax Court held that an unrelated manufacturing corporation in a contract manufacturing arrangement with a CFC cannot be treated as a branch or similar establishment of the CFC. In *Vetco, Inc. v. Commissioner*, 95 TC 579 (1990), the Tax Court held that a wholly owned subsidiary of a CFC in a contract manufacturing arrangement with the CFC also cannot be treated as a branch or similar establishment of the CFC.

In Rev. Rul. 97-48 the IRS revoked Rev. Rul. 75-7. Rev. Rul. 97-48 states that the IRS will follow *Ashland Oil, Inc. v. Commissioner* and *Vetco, Inc. v. Commissioner*, and therefore confirms that the IRS will not treat a separate contract manufacturer as a branch for purposes of section 954(d)(2). In addition, Rev. Rul. 97-48 rules that the activities of a contract manufacturer cannot be attributed to a CFC for purposes of either

section 954(d)(1) or section 954(d)(2) to determine whether the income of a CFC is FBCSI. However, the ruling does not address the circumstances under which the activities of the CFC itself may qualify as manufacturing when a contract manufacturing or similar arrangement is in place. See §601.601(d)(2)(ii)(b).

#### D. Business Developments

Final regulations addressing FBCSI were first published in 1964 (T.D. 6734, 1964-1 C.B. 237 [29 FR 6392]). Since then, global economic expansion and globalization have led to significant changes in manufacturing. Many multinational groups have extensive manufacturing networks that straddle geographic borders. These cross-border manufacturing networks are created primarily to leverage expertise and cost efficiencies. In addition, the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords. Accordingly, updated rules in this area are important to the continued competitiveness of U.S. businesses operating abroad.

#### Explanation of Provisions

In response to the growing importance of contract manufacturing and other manufacturing arrangements, the Treasury Department and the IRS propose to modernize the FBCSI regulations in light of current business structures and practices that are inadequately addressed by the current regulations. Specifically, the proposed regulations address: (1) the application of the manufacturing exception where the physical manufacturing test is not satisfied by the CFC but where the CFC, and/or a branch of the CFC, is otherwise involved in the manufacturing process; (2) the application of the branch rule to business structures involving the use of one or more branches engaged in manufacturing, producing, constructing, growing, or extracting activities; and (3) other miscellaneous branch rule issues. Certain portions of these proposed regulations restate changes that were previously proposed in REG-104537-97, 1998-1 C.B. 892 [63 FR 14669] and withdrawn in REG-113909-98, 1999-2 C.B. 125 [64 FR 37727].

#### A. Application of the manufacturing exception where the physical manufacturing test is not satisfied by the CFC but the CFC is involved in the manufacturing process — Substantial contribution to manufacturing

Section 954(d)(1) includes, as FBCSI, income derived in connection with the purchase of personal property from a related person and “its” sale to any person, and income derived in connection with the purchase of personal property from any person and “its” sale to a related person. Some taxpayers argue that use of the word “its” implies that the property sold must be the same property that is purchased for the sales income to be FBCSI. Accordingly, these taxpayers assert that where the personal property purchased by the CFC is manufactured such that the property purchased is not the same as the property sold by the CFC, the property sold by the CFC is not the property purchased and therefore the sale of such property does not generate FBCSI, even if the CFC itself performs little or no part of the manufacture of that property. They further argue that the manufacturing exception under §1.954-3(a)(4)(i) provides a safe harbor but does not define the universe of cases in which personal property sold by a CFC is considered to be different from the property purchased by the CFC for purposes of determining FBCSI. In addition, they argue that §1.954-3(a)(4)(i) supports their view because it states, in part, that “[a] foreign corporation will be considered, for purposes of this subparagraph, to have manufactured, produced, or constructed personal property which it sells if the property sold is in effect not the property which it purchased.”

The Treasury Department and the IRS believe that the position taken by these taxpayers is contrary to existing law, and results from an incorrect reading of section 954(d)(1) and §1.954-3(a)(4)(i). Section 954(d)(1) requires only a purchase of personal property and the sale of that personal property by the CFC with no indication as to form. Moreover, section 954(d)(1)(A) limits FBCSI to income derived in connection with the purchase (or sale) of personal property that is manufactured, produced, grown, or extracted outside of the CFC’s country of organization, thereby indicating that section 954(d)(1) is concerned with

the segregation of purchasing or selling and manufacturing into different jurisdictions, not merely with whether the property was manufactured.

Section 1.954-3(a)(4) provides the only set of rules under which a change in form of personal property is considered relevant for purposes of determining FBCSI. The first sentence of Treas. Reg. §1.954-3(a)(4) sets forth the general rule that “foreign base company sales income does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased.” The third sentence of that paragraph explains that “the property sold will be considered, for purposes of this subparagraph, as not being the property which is purchased if the provisions of subdivision (ii) or (iii) of this subparagraph are satisfied.” The plain language of the regulation, as well as the examples, clarify that in order to satisfy §1.954-3(a)(4)(ii) or (iii) the relevant manufacturing activities must be performed by the CFC itself. See, for example, *Electronic Arts, Inc. v. Commissioner*, 118 TC 226, 265 (2002) (stating that “petitioner’s focus on certain language in section 1.954-3(a)(4), Income Tax Regs., overlooks the regulation’s requirement that various actions have been done ‘by’ the corporation being evaluated”). See also, *Medchem v. Commissioner*, 116 TC 308 (2001).

Further, this regulation was issued shortly after the statute became effective, and is consistent with the legislative history, which contemplates that property sold will be considered different from the property purchased only when the CFC itself manufactures that property. See S. Rep. No. 1881, 87<sup>th</sup> Cong., 2d Sess. (1962), 1962-3 C.B. 841, 949 (stating that “[i]n a case in which a controlled foreign corporation purchases parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased.”)

The proposed regulations clarify that for purposes of determining FBCSI personal property sold by a CFC will be

considered to be the property purchased by the CFC regardless of whether it is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product, except as specifically provided by the same country manufacture exception contained in §1.954-3(a)(2) and the manufacturing exception contained in §1.954-3(a)(4). Therefore, the only time that the manufacture of a product will affect whether income is FBCSI is when the manufacture of the product is performed by the CFC or performed in the country of organization of the CFC. With respect to the manufacturing exception contained in §1.954-3(a)(4), the proposed regulations clarify that a CFC qualifies for the manufacturing exception only if the CFC, acting through its employees, manufactured the relevant product within the meaning of §1.954-3(a)(4)(i). The proposed regulations also further provide rules to determine whether the activities of a branch or similar establishment outside the country in which the CFC is incorporated have substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation, and thus whether under section 954(d)(2) the income attributable to the branch or similar establishment constitutes FBCSI of the CFC.

The Treasury Department and the IRS recognize, however, that due to business considerations in the global marketplace, personal property may be manufactured pursuant to a contract manufacturing arrangement under which the CFC engages in activities related to the manufacture of the property (for example, oversight, direction and control over the contract manufacturer) but does not satisfy the physical manufacturing test. In certain of these cases, the Treasury Department and the IRS believe that the CFC should qualify for the manufacturing exception to FBCSI. Accordingly, the proposed regulations modify §1.954-3(a)(4) to provide that a CFC that provides a “substantial contribution” with respect to the manufacture, production, or construction of personal property, but that could not satisfy the physical manufacturing test, may have manufactured such property for purposes of the manufacturing exception. Specifically, proposed §1.954-3(a)(4)(i) provides that,

in addition to proposed §1.954-3(a)(4)(ii) and (iii), a taxpayer may qualify for the manufacturing exception by satisfying the “substantial contribution test” in proposed §1.954-3(a)(4)(iv). Pursuant to proposed §1.954-3(a)(4)(iv)(a), a CFC will satisfy the substantial contribution test with respect to personal property only if the facts and circumstances evidence that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture of that property.

Factors to be considered in determining whether a CFC makes a substantial contribution to the manufacture of personal property include but are not limited to: (1) oversight and direction of the activities or process (including management of the risk of loss) pursuant to which the property is manufactured under the principles of §1.954-3(a)(4)(ii) or (iii); (2) performance of activities that are considered in, but insufficient to satisfy the tests provided in §1.954-3(a)(4)(ii) and (iii); (3) control of the raw materials, work-in-process and finished goods; (4) management of the manufacturing profits; (5) material selection; (6) vendor selection; (7) control of logistics; (8) quality control; and (9) direction of the development, protection, and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product.

In light of the addition of the new test contained in proposed §1.954-3(a)(4)(iv), the interaction between several existing regulation sections and the new test is clarified. First, the existing manufacturing exceptions under §1.954-3(a)(4)(ii) and (iii) are modified to clarify that the applicability of the tests under §1.954-3(a)(4)(ii) and (iii) are restricted to cases in which physical transformation or physical assembly or conversion of component parts is conducted by the selling corporation.

Second, the definition of manufacturing for purposes of the same country manufacture exception contained in §1.954-3(a)(2) is modified to exclude manufacturing as defined under the substantial contribution test, and to ensure that the modifications to the existing manufacturing exceptions under §1.954-3(a)(4)(ii) and (iii) do not narrow the same country manufacture exception. The Treasury Department and the IRS did not intend these regu-

lations to change the scope of the same country manufacture exception. Section 1.954-3(a)(2) excludes manufacturing as defined under the substantial contribution test because a rule that expanded the definition of manufacturing to include §1.954-3(a)(4)(iv) activities for purposes of the same country manufacture exception could prove difficult to administer. Such a rule could require an assessment of activities other than physical manufacturing conducted by an unrelated person. Modifying §1.954-3(a)(2) ensures that the modifications to the existing manufacturing exceptions under §1.954-3(a)(4)(ii) and (iii) do not narrow the same country manufacture exception by clarifying that property manufactured in the country of organization of the selling corporation will qualify for the same country manufacture exception regardless of whose employees engage in manufacturing activities that satisfy the principles of §1.954-3(a)(4)(ii) or (iii).

Third, the proposed regulations modify §1.954-3(a)(6), which addresses the application of the manufacturing exception to a CFC's distributive share of partnership income where the partnership manufactures and sells personal property. The reference to "the separate activities or property of the controlled foreign corporation or any other person," in §1.954-3(a)(6) was intended to clarify that the activities of another person could not be attributed to the partnership for purposes of applying the manufacturing exception. Because these proposed regulations clarify that no attribution is allowed for purposes of applying the manufacturing exception that language is now unnecessary and is therefore removed. Section 1.954-3(a)(6) is also modified consistent with the modifications to §1.954-3(a)(4) providing that a CFC may only qualify for the manufacturing exception through the activities of its employees.

#### *B. Application of the branch rule to business structures involving the use of more than one branch engaged in manufacturing*

Proposed §1.954-3(b)(2)(ii)(c)(2) creates a rebuttable presumption with respect to the application of the substantial contribution test where a CFC claims to satisfy the substantial contribution test with respect to the activities of a branch of that

CFC that satisfies §1.954-3(a)(4)(ii) or (iii). Under this rebuttable presumption, if a branch of a CFC satisfies the physical manufacturing test with respect to personal property sold by the remainder of the CFC, the remainder of the CFC will be presumed not to make a substantial contribution to the manufacture of that personal property unless the CFC can rebut that presumption to the satisfaction of the Commissioner.

The Treasury Department and the IRS believe that these rules are necessary as a backstop to the branch rule. In the absence of the rebuttable presumption, a rule permitting a CFC to qualify for the manufacturing exception based upon its contribution to the manufacturing activities of a branch would prove difficult to administer. Such a rule could encourage a CFC to elect classification of its subsidiaries that engage in manufacturing activities as disregarded entities, obfuscating the division of manufacturing labor and income between the CFC and its branches. Of course, the presumption may be rebutted and any adverse consequences alleviated by incorporating the branch that satisfies the physical manufacturing test.

Although §1.954-3(b)(1)(i)(c) provides a rule addressing the use of multiple sales or purchase branches, §1.954-3(b)(1)(ii) does not provide a corollary rule for the use of multiple manufacturing branches. The Treasury Department and the IRS believe that the lack of a specific rule addressing the use of more than one manufacturing branch does not currently limit the general manufacturing branch rule of §1.954-3(b)(1)(ii)(a) from applying to each manufacturing branch of a CFC in a case where a CFC performs manufacturing activities through more than one branch or similar establishment. Rather, such an application is consistent with the rules regarding multiple sales or purchase branches. Nonetheless, for clarity, the proposed regulations set forth rules addressing the use of multiple manufacturing branches.

The proposed regulations set forth two rules addressing the application of the manufacturing branch tax rate disparity test to multiple manufacturing branches.

Proposed §1.954-3(b)(1)(ii)(c)(2) addresses situations in which multiple branches each perform manufacturing activities with respect to separate items of

personal property that are then sold by the CFC. Consistent with the rule for multiple sales branches, the proposed regulations require the separate application of the manufacturing branch tax rate disparity test to each branch that is manufacturing a separate item of personal property.

Proposed §1.954-3(b)(1)(ii)(c)(3) addresses situations in which multiple branches, or one or more branches and the remainder of the CFC, perform manufacturing activities with respect to the same item of personal property that is then sold by the CFC. When multiple branches, or one or more branches and the remainder of the CFC, perform manufacturing activities with respect to the same item of personal property, the manufacturing branch tax rate disparity test is applied by giving satisfaction of the physical manufacturing test precedence over other contributions to manufacturing. Therefore, if only one branch, or only the remainder of the CFC, satisfies the physical manufacturing test of §1.954-3(a)(4)(ii) or (iii), then the location of that branch or the remainder of the CFC will be the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test. If more than one branch, or one or more branches and the remainder of the CFC, each satisfy the physical manufacturing test, then the branch or the remainder of the CFC located or organized in the jurisdiction that would impose the lowest effective rate of tax will be the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test.

If none of the branches nor the remainder of the CFC satisfies the physical manufacturing test, but the CFC as a whole satisfies the substantial contribution test contained in proposed §1.954-3(a)(4)(iv), then the location of manufacturing of the personal property will be the location of the branch or the remainder of the CFC that provides the predominant amount of the CFC's substantial contribution to manufacturing. Whether any branch or the remainder of the CFC provides a predominant amount of the CFC's contribution to manufacturing is determined by applying the facts and circumstances test provided in §1.954-3(a)(4)(iv) to weigh the contribution to manufacturing of each branch or the remainder of the CFC. If a predominant

amount of the CFC's contribution to manufacturing is not provided by any one location, the location of manufacturing of the personal property for purposes of applying the manufacturing branch tax rate disparity test will be that place (either the remainder of the CFC or one of its branches) where manufacturing activity is performed and which would impose the highest effective rate of tax when applying either §1.954-3(b)(1)(i)(b) or (ii)(b).

Because the proposed regulations address cases in which two or more branches, or one or more branches and the remainder of the CFC, perform manufacturing activities related to the manufacture of the same item of property, §1.954-3(b)(2)(ii)(a) is modified to clarify the application of the branch rule where manufacturing activities are performed in more than one location. In such cases, proposed §1.954-3(b)(2)(ii)(a) provides that, for purposes of treating the location of sales or purchase income as a separate corporation for purposes of determining whether FBCSI is incurred, that separate corporation will exclude any branch or the remainder of the CFC that would be treated as a separate corporation, if the hypothetical rate imposed by the jurisdiction of each such branch or the remainder of the CFC were separately tested against the effective rate of tax imposed on the sales or purchase income under the relevant tax rate disparity test.

### C. Miscellaneous Branch Rule Issues

The Treasury Department and the IRS also propose to amend certain other aspects of §1.954-3(b) as follows:

#### 1. Definition of a manufacturing branch

While §1.954-3(b)(1)(ii)(a) defines a manufacturing branch as a branch or similar establishment through which a CFC carries on manufacturing activities, it does not explicitly require that §1.954-3(a)(4)(i) be satisfied by the CFC as a whole in order for the manufacturing branch rule to apply. The Treasury Department and the IRS believe that a manufacturing branch only exists with respect to personal property sold by a CFC if the CFC (including any branch of that CFC) has manufactured that property. Accordingly, proposed §1.954-3(b)(1)(ii)(a) clarifies this point by providing that the

manufacturing branch rule applies only where a CFC (including any branch of the CFC) satisfies the manufacturing requirement under proposed §1.954-3(a)(4).

#### 2. Modification of §1.954-3(b)(2)(ii)(e)

Section 1.954-3(b)(2)(ii)(e) provides that income derived by a branch or similar establishment, or by the remainder of the CFC, will not be FBCSI if the income would not be so considered if it were derived by a separate CFC under like circumstances. For example, if a branch of a CFC purchases personal property from an unrelated person and sells the property to an unrelated person without any involvement by the remainder of the CFC, the branch rule will not apply to create a related party transaction between the branch and the remainder of the CFC. Therefore the purchase and sale of that personal property by the branch will not generate FBCSI.

The proposed regulations provide that the substantial contribution test generally applies to a CFC that sells personal property where another person (for example, a second CFC) satisfies the physical manufacturing test with respect to that property. However, a negative presumption applies where a CFC claims to satisfy the substantial contribution test with respect to income from the sale of personal property where the physical manufacturing test is satisfied by a branch of that CFC. The effect of these rules is that, where a CFC seeks to rely on the substantial contribution test with respect to the income from the sale of personal property manufactured (within the meaning of §1.954-3(a)(4)(ii) or (iii)) by one or more of its branches, but cannot rebut the negative presumption to the satisfaction of the Commissioner, a branch or the remainder of a CFC may have FBCSI where a separate CFC would not. Therefore, to integrate the rules regarding the substantial contribution test and its application under the branch rule, proposed §1.954-3(b)(2)(ii)(e) excepts from its general rule cases in which a branch satisfies the physical manufacturing test with respect to personal property and the remainder of the controlled foreign corporation fails to rebut the presumption that it does not satisfy the substantial contribution test with respect to the activities of that manufacturing branch.

In addition, consistent with §1.954-3(b)(2)(ii)(f), §1.954-3(b)(2)(ii)(e) is modified to clarify that it applies only for purposes of paragraph (b) of §1.954-3 (that is, the branch rule). This clarifies that in no event will the branch rule cause income not to be FBCSI if that income would otherwise be FBCSI under section 954(d)(1). For example, assume a CFC incorporated in Country Y purchases personal property from a related party and has that property manufactured by a contract manufacturer in Country Z. If the CFC does not perform any other activity with respect to the manufacture of the property, and if the CFC sells the manufactured property through a branch located in Country Z for use, consumption, or disposition outside of Country Y, the income from the sale of that property is FBCSI under section 954(d)(1). If the branch located in Country Z were a separate CFC the income would not be FBCSI because it would be selling personal property manufactured in its country of organization, Country Z. However, because the income would be FBCSI to the CFC under section 954(d)(1), proposed §1.954-3(b)(2)(ii)(e) does not apply to create a different result.

#### 3. Modification of §1.954-3(b)(2)(i)(b), (b)(2)(ii)(b) and (b)(4), Example 3

Commentators have noted that §1.954-3(b)(2)(i)(b) and (ii)(b) can be read to cause a branch that purchases from unrelated persons and sells to unrelated persons to have FBCSI even where the remainder of the CFC has no connection with the personal property that is sold. Although §1.954-3(b)(2)(ii)(e) should prevent such a result, commentators note that a contrary reading is possible because the sales branch rules of §1.954-3(b)(2)(i)(b) and (ii)(b) apply, in part, with respect to personal property manufactured, produced, constructed, grown, or extracted by, or personal property purchased or sold by the "controlled foreign corporation" (as opposed to by the "remainder" of the controlled foreign corporation). For example, in a case in which a branch both manufactures and sells personal property, the branch could be considered to sell on behalf of the remainder of the CFC because the branch's manufacturing activities would be consid-

ered to be manufacturing activities of the CFC, thereby triggering the application of §1.954-3(b)(2)(ii)(b). Further, commentators note that §1.954-3(b)(4), *Example 3* appears to support this reading because in that example a branch of a corporation purchases from a related person and sells to an unrelated person, and the branch is treated as selling that property on behalf of the remainder of the CFC, even though the remainder of the corporation does not manufacture, purchase, or sell the personal property.

Section 1.954-3(b)(2)(i)(b) and (ii)(b) are intended to apply only to purchasing or selling by a branch with respect to personal property manufactured, purchased, or sold by “the remainder of” the CFC (including any branch treated as the remainder of the CFC). For example, the branch rule could apply in a case where personal property is manufactured by the CFC in the country of organization of the CFC and then sold by a branch of the CFC located outside of the country of organization of the CFC. However, the branch rule does not apply where, for example, a branch of the CFC purchases personal property from an unrelated party and sells it to an unrelated party without any involvement by the remainder of the CFC. Accordingly, the proposed regulations amend §1.954-3(b)(2)(i)(b) and (ii)(b) by adding the words “remainder of” before each place where the words “controlled foreign corporation” appear in those paragraphs and by adding the words “(or by any branch treated as the remainder of the CFC)” after each place where the words “controlled foreign corporation” appear in those paragraphs. Consistent with this change, the proposed regulations revise the rationale for the result in §1.954-3(b)(4), *Example 3* as described below.

In §1.954-3(b)(4), *Example 3*, a branch of a second-tier CFC purchases finished goods from the first-tier CFC and sells 90 percent of the product for use, consumption, or disposition outside of the country in which the branch is located and the country of organization of the second-tier CFC. The remainder of the second-tier CFC does not engage in any manufacturing or selling activities. The sales branch tax rate disparity test is met in comparison to the effective tax rate of the second-tier CFC (the first-tier CFC and second-tier CFC are organized in the same country).

The example concludes that since the sales branch tax disparity test is met, the branch is treated as a separate CFC and is treated as selling personal property on behalf of the second-tier CFC and therefore the 90 percent of sales made for use, consumption, or disposition outside of the branch’s country result in FBCSI.

The rationale of the example is incorrect because the branch is not selling on behalf of the second-tier CFC because the remainder of the second-tier CFC (not including the branch) does not manufacture, purchase, or sell the personal property. Therefore, §1.954-3(b)(2)(i)(b) and (ii)(b) do not apply. However, the result is correct because the branch, treated as a separate corporation, is purchasing from a related person, the first-tier CFC, organized outside of the branch’s country and selling to persons outside the branch’s country and the branch is located in a jurisdiction that satisfies the sales branch tax rate disparity test with respect to the income from the sale of the personal property. Accordingly, the proposed regulations revise §1.954-3(b)(4), *Example 3* to provide the correct rationale for the result. In addition, the result in §1.954-3(b)(4), *Example 3* is further revised to add two alternative factual scenarios (purchase from an unrelated party, and manufacture within the meaning of proposed §1.954-3(a)(4)(iv) by the selling branch) to illustrate the point that, in general, a branch will not have FBCSI if a separate CFC would not have FBCSI under like circumstances.

### **Proposed Effective/Applicability Date**

These regulations will apply to taxable years of CFCs beginning on or after the date they are published as final regulations in the **Federal Register**, and for taxable years of United States shareholders in which or with which such taxable years of the CFCs end.

### **Reliance on Proposed Regulations**

Until these regulations are finalized, taxpayers may choose to apply these regulations in their entirety to all open tax years as if they were final regulations.

### **Request for Comments**

The Treasury Department and the IRS request comments on all aspects of

these proposed regulations, including comments regarding the substantial contribution test, and the activities listed in §1.954-3(a)(4)(iv)(b). In particular, comments are requested on whether one or more safe harbors should be added to the substantial contribution test. In drafting the proposed regulations, the Treasury Department and the IRS considered a number of approaches to a safe harbor but ultimately chose to request comments in this regard because of difficulties in fashioning a safe harbor that would be flexible enough to apply across various industries and across a range of different types of manufacturing arrangements. Among the safe harbors considered in drafting the proposed regulations were: (1) a list of mandatory activities; (2) a cost based test; (3) a compensation based test; (4) a value based test; (5) a tax rate disparity based test; and (6) a percentage based test comparing the compensation paid to employees of the CFC for performing activities related to the manufacturing process vs. the total cost for all activities related to the manufacturing process (that is, including costs paid to a contract manufacturer but excluding the cost of raw materials and marketing intangibles). In addition, the Treasury Department and the IRS request comments as to whether the requirement, under the manufacturing exception from foreign base company sales income, that the activities of the CFC be performed by its employees, should permit commercial arrangements where individuals performing services for the CFC, while not on its payroll, are nevertheless controlled by employees of the CFC.

Comments are also requested on whether it would be appropriate to add an anti-abuse rule similar to the foreign base company services substantial assistance test announced in Notice 2007-13 to prevent a CFC from qualifying for the manufacturing exception based on the application of the substantial contribution test in cases in which substantially all of the direct or indirect contributions to the manufacture of personal property provided collectively by the CFC and any related United States person is provided by one or more related United States persons. Such a rule might provide, for example, that where (1) the United States parent of a CFC provides 45 percent of the manufacturing contribution, (2) the CFC provides 5



percent of the manufacturing contribution, and (3) an unrelated contract manufacturer provides 50 percent of the manufacturing contribution to the personal property, the CFC does not make a substantial contribution to the manufacture of that property because a related United States person provides 80 percent or more of the contribution to the manufacture of the property (90 percent in this case, 45/50) provided collectively by the CFC and any related United States person. Such a rule was considered but ultimately not included in the proposed regulations and comments are requested on whether or not such a rule should be added to the final regulations. See §601.601(d)(2)(ii)(b).

In addition, comments are requested on the multiple manufacturing branch rules. First, comments are requested on whether the negative presumption rule concerning cases in which the selling branch or the remainder of the CFC performs activities described in proposed §1.954-3(a)(4)(iv) is more appropriate than an alternative rule that would deny the use of the test contained in proposed §1.954-3(a)(4)(iv) in cases in which a branch of the CFC manufactures the property within the meaning of proposed §1.954-3(a)(4)(ii) or (iii). Second, comments are requested on the consequences of and possible alternatives to proposed §1.954-3(b)(1)(ii)(c)(3)(e), which provides that if a predominant amount of the CFC's substantial contribution is not provided by any one location, the location of manufacturing of the personal property will be considered to be that location (either the remainder of the CFC or one of its branches) which imposes the highest effective rate of tax that would be imposed on the sales income, among those locations where manufacturing activity related to the generation of that income is performed. The Treasury Department and the IRS considered a rule that would allow taxpayers to alternatively use the mean effective rate of tax among the locations where manufacturing activity is performed, so long as that effective rate of tax was within a set number of percentage points of the highest effective tax rate that would be imposed by any jurisdiction in which a manufacturing branch or the remainder of the CFC was located or organized. However, the Treasury Department and the IRS were concerned about the complexity of such a rule. The Treasury

Department and the IRS request comments on whether this or other alternatives to the highest rate test would be appropriate. Finally, comments are requested on whether any modifications to §1.954-3(b)(1)(i)(b) and (b)(1)(ii)(b) should be adopted to make the rules concerning the comparison of effective rates of tax easier to apply.

### Special Analyses

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

### Comments and Requests for Public Hearing

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

### Drafting Information

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

\* \* \* \* \*

### Proposed Amendments to the Regulations

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

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 continues to read in part as follows:

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

Par. 2. Section 1.954-3 is amended by:

1. Adding a new sentence after the first sentence of paragraph (a)(1)(i), and by revising the second sentence of *Example 1* in paragraph (a)(1)(iii), and the first sentence of *Example 2* in paragraph (a)(1)(iii).

2. Revising the third sentence of paragraph (a)(2).

3. Revising paragraph (a)(4)(i), and the first sentences of paragraphs (a)(4)(ii) and (iii), and by adding paragraph (a)(4)(iv).

4. Revising the text of paragraph (a)(6)(i).

5. Adding a new sentence to the end of paragraph (b)(1)(ii)(a).

6. Redesignating the text of paragraph (b)(1)(ii)(c) as paragraph (b)(1)(ii)(c)(I), and adding a paragraph heading to newly designated paragraph (b)(1)(ii)(c).

7. Adding paragraphs (b)(1)(ii)(c)(2), and (c)(3).

8. Revising paragraph (b)(2)(i)(b).

9. Adding a new sentence to the end of paragraph (b)(2)(ii)(a), and revising paragraph (b)(2)(ii)(b).

10. Redesignating paragraph (b)(2)(ii)(c) as paragraph (b)(2)(ii)(c)(I), revising the paragraph heading of paragraph (b)(2)(ii)(c), adding paragraph (b)(2)(ii)(c)(2), and revising paragraph (b)(2)(ii)(e).

11. Revising *Example 3* in paragraph (b)(4).

12. Adding paragraph (d).

The additions and revisions read as follows:

#### §1.954-3 Foreign Base Company Sales Income.

(a) \* \* \*

(1) *In general*—(i) *General rules*. \* \* \* For purposes of the preceding sentence, except as provided in paragraphs (a)(2) and (a)(4) of this section, personal property sold by a controlled foreign corporation will be considered to be the

same property that was purchased by the controlled foreign corporation regardless of whether the personal property is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product. \* \* \*

\* \* \* \* \*

*Example 1.* \* \* \* Corporation A purchases from M Corporation, a related person, articles manufactured in the United States and sells the articles to P, not a related person, for delivery and use in foreign country Y. \* \* \*

*Example 2.* Corporation A in *Example 1* also purchases from P, not a related person, articles manufactured in country Y and sells the articles to foreign corporation B, a related person, for use in foreign country Z. \* \* \*

\* \* \* \* \*

(2) \* \* \* The principles set forth in paragraphs (a)(4)(i), (a)(4)(ii), and (a)(4)(iii) of this section apply under this paragraph (a)(2) in determining what constitutes manufacture, production, or construction of personal property, excluding, in the case of manufacture, production, or construction by a person other than the controlled foreign corporation, the requirement set forth in paragraph (a)(4)(i) of this section that the provisions of paragraphs (a)(4)(ii) and (a)(4)(iii) of this section may only be satisfied through the activities of that person's employees. \* \* \*

\* \* \* \* \*

(4) *Property manufactured, produced, or constructed by the controlled foreign corporation—(i)—In general.* Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation in whole or in part from personal property which it has purchased. A controlled foreign corporation will have manufactured, produced, or constructed personal property which the corporation sells only if such corporation satisfies the provisions of paragraphs (a)(4)(ii), (a)(4)(iii), or (a)(4)(iv) of this section through the activities of its employees with respect to such property. A controlled foreign corporation will not be treated as having manufactured, produced, or constructed personal property which the corporation sells merely because the property is sold in a different form than the form in which it was purchased. For rules

of apportionment in determining foreign base company sales income derived from the sale of personal property purchased and used as a component part of property which is not manufactured, produced, or constructed, see paragraph (a)(5) of this section.

(ii) \* \* \* If personal property purchased by a foreign corporation is substantially transformed by such foreign corporation prior to sale, the property sold by the selling corporation is manufactured, produced, or constructed by such selling corporation. \* \* \*

(iii) \* \* \* If purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product, rather than the sale of component parts, if the assembly or conversion of the component parts into the final product by the selling corporation involves activities that are substantial in nature and generally considered to constitute the manufacture, production, or construction of property. \* \* \*

(iv) *Substantial contribution to manufacturing of personal property—(a)—In general.* This paragraph (a)(4)(iv) applies only if a controlled foreign corporation does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section, but the personal property purchased by a controlled foreign corporation would be considered to be manufactured, produced, or constructed prior to sale (under the principles of paragraphs (a)(4)(ii) or (iii) of this section) by the controlled foreign corporation if the manufacturing, producing, and constructing activities undertaken with respect to that property prior to sale were undertaken by the controlled foreign corporation through the activities of its employees. If this paragraph (a)(4)(iv) applies, the personal property sold by the controlled foreign corporation is manufactured, produced, or constructed by such controlled foreign corporation only if the facts and circumstances evidence that the controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold. The determination of whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal

property sold will involve, but will not necessarily be limited to, consideration of the activities set forth in paragraph (a)(4)(iv)(b) of this section. The weight given to any activity (whether or not set forth) will vary with the facts and circumstances of the particular business. The presence or absence of any activity, or of a particular number of activities, is not determinative. Further, the fact that other persons make contributions to the manufacture, production, or construction of personal property prior to sale does not necessarily prevent the controlled foreign corporation from making a substantial contribution to the manufacture, construction, or production of that property through the activities of its employees.

(b) *Activities.* Activities of a controlled foreign corporation's employees to be considered in determining whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacture, construction, or production of personal property include but are not limited to—

(1) Oversight and direction of the activities or process (including management of the risk of loss) pursuant to which the property is manufactured, produced, or constructed under the principles of paragraphs (a)(4)(ii) or (iii) of this section;

(2) Performance of activities that are considered in but that are insufficient to satisfy the tests provided in paragraphs (a)(4)(ii) and (a)(4)(iii) of this section;

(3) Control of the raw materials, work-in-process and finished goods;

(4) Management of the manufacturing profits;

(5) Material selection;

(6) Vendor selection;

(7) Control of logistics;

(8) Quality control; and

(9) Direction of the development, protection, and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product.

(c) The rules of this paragraph (a)(4)(iv) are illustrated by the following examples:

*Example 1. No substantial contribution to manufacturing.* (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation that performs the physical conversion outside of FS's country of organization, pursuant to a contract man-

ufacturing arrangement. Product X is then sold by FS for use outside of FS's country of organization. At all times, FS retains control of the raw material, work-in-process, and finished goods, as well as the intangibles used in the conversion process. FS retains the right to oversee and direct the physical conversion of Product X by CM but does not regularly exercise, through its employees, its powers of oversight or direction.

(ii) *Result.* FS does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section because FS does not, through the activities of its employees, substantially transform, convert or assemble personal property into Product X. However, Product X was manufactured (by CM), and therefore this paragraph (a)(4)(iv) applies. FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere contractual ownership of materials and intellectual property and contractual rights to exercise powers of direction and control (without the exercise of those powers) are not sufficient to satisfy this paragraph (a)(4)(iv). Therefore, FS is not considered to have manufactured Product X under paragraph (a)(4)(i) of this section.

*Example 2. Substantial contribution to manufacturing, unrelated manufacturer.* (i) *Facts.* Assume the same facts as in *Example 1*, except for the following. FS, through its employees, is engaged in product design and quality control. Employees of FS regularly exercise the right to oversee and direct the activities of CM in the manufacture of Product X.

(ii) *Result.* FS does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X because FS does not, through the activities of its employees, substantially transform, convert or assemble personal property into Product X. However, Product X was manufactured (by CM), and therefore this paragraph (a)(4)(iv) applies. FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore FS is considered to have manufactured Product X. The analysis and conclusion in this *Example 2* would be the same if CM were a corporation that was related to FS.

*Example 3. Employees of another person.* (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM, an unrelated contract manufacturer located in Country C. CM uses employees of another corporation to operate its manufacturing plant and convert the raw materials into Product X. Apart from the physical conversion of the raw materials into Product X, employees of FS perform all of the other activities with respect to the manufacture of Product X (for example, oversight and direction of the manufacturing process, control of raw materials, control of logistics, vendor selection, quality control). FS sells Product X for use, consumption or disposition outside Country M.

(ii) *Result.* If the manufacturing activities undertaken with respect to Product X prior to sale were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(iii) of this section

with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. FS satisfies the test under this paragraph (a)(4)(iv) because it makes a substantial contribution through the activities of its employees to the manufacture of Product X. Therefore, FS is considered to have manufactured Product X. If CM's manufacturing plant were located in Country M, the test in paragraph (a)(2) of this section could be satisfied even if CM did not manufacture Product X through the activities of its employees.

*Example 4. Automated manufacturing.* (i) *Facts.* FS, a controlled foreign corporation, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(ii) of this section) into Product X by CM, an unrelated corporation located outside of FS's country of organization, pursuant to a contract manufacturing arrangement. Product X is then sold by FS to related and unrelated persons for use outside of FS's country of organization. Under the contract manufacturing arrangement, CM is responsible for the physical transformation of the raw materials into Product X. At all times, FS retains ownership of the raw material, work-in-process, and finished goods. FS retains the right to oversee and direct the physical conversion of Product X by CM but does not regularly exercise, through its employees, its powers of oversight or direction. FS is the owner of sophisticated software and network systems that remotely and automatically (without human involvement) take orders, route them to CM, order raw materials, and perform quality control. FS has a small number of computer technicians who monitor the software and network systems to ensure that they are running smoothly and to apply any necessary patches or fixes. The software and network systems were developed by employees of DP, the U.S. corporate parent of FS, pursuant to a cost sharing agreement between DP and FS. DP employees regularly supervise the computer technicians, evaluate the results of the automated manufacturing business, and make ongoing operational decisions, including with regard to acceptable performance of the manufacturing process, stoppages of that process, and product and process redesign and updates to meet the needs of the business and its customers. DP employees develop and provide to FS all of the upgrades to the software and network systems. DP also has employees who control the other aspects of the manufacturing process such as product design, vendor and material selection, management and retention of the manufacturing profits, and the selection of CM.

(ii) *Result.* FS does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X because FS does not, through the activities of its employees, substantially transform, convert or assemble personal property into Product X. If the manufacturing activities undertaken with respect to Product X between the time the raw materials were purchased and the time Product X was sold were undertaken by FS through the activities of its employees, FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(iii) of this section with respect to Product X. Therefore, this paragraph (a)(4)(iv) applies. FS does not satisfy the test under this paragraph (a)(4)(iv) because it does not make a substantial contribution through the activities of its employees to the manufacture of Product X. Mere contractual ownership of materials

and intellectual property together with contractual rights to exercise powers of direction and control and a small number of technical employees are not sufficient to satisfy this paragraph (a)(4)(iv). FS's primary contribution to the manufacture of Product X is the provision of the software and network systems to CM. Substantial operational responsibilities and decision making are exercised by DP employees who direct the activities of the FS employees. Therefore, FS is not considered to have manufactured Product X.

\* \* \* \* \*

(6) \* \* \* (i) \* \* \* To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under §1.952-1(g), the property sold will be considered to be manufactured, produced or constructed by the controlled foreign corporation, within the meaning of paragraph (a)(4) of this section, only if the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account the activities of the employees of, and property owned by, the partnership.

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(ii) \* \* \*

(a) \* \* \*The provisions of this paragraph (b)(1)(ii)(a) will not apply unless the controlled foreign corporation (including any branches or similar establishments of such controlled foreign corporation) manufactures, produces, or constructs such personal property within the meaning of paragraph (a)(4)(i) of this section.

\* \* \* \* \*

(c) *Use of more than one branch—(1) Use of one or more sales or purchase branches in addition to a manufacturing branch.* \* \* \*

(2) *Use of more than one branch to manufacture, produce, construct, grow, or extract separate items of personal property.* If a controlled foreign corporation carries on manufacturing, producing, constructing, growing, or extracting activities with respect to separate items of personal property by or through more than one branch or similar establishment located outside the country under the laws

of which such corporation is created or organized, then paragraphs (b)(2)(ii)(b) and (c) of this section will be applied separately to each such branch or similar establishment (by treating such branch or similar establishment as if it were the only branch or similar establishment of the controlled foreign corporation and as if any other branches or similar establishments were separate corporations) in determining whether the use of such branch or similar establishment has substantially the same tax effect as if such branch or similar establishment were a wholly owned subsidiary corporation of the controlled foreign corporation. The application of this paragraph (b)(1)(ii)(c)(2) is illustrated by the following example:

*Example. Multiple branches that satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section.* (i) *Facts.* FS is a controlled foreign corporation organized in Country M. FS operates two branches, Branch A and Branch B located in Country A and Country B, respectively. Branch A and Branch B each manufacture separate items of personal property (Product X and Product Y respectively) within the meaning of paragraph (a)(4)(ii) or (iii) of this section. Raw materials used in the manufacture of Product X and Product Y are purchased by FS from an unrelated person. FS engages in activities in Country M to sell Product X and Product Y to a related person for use, disposition or consumption outside of Country M. Employees of FS located in Country M perform only sales functions. The effective rate imposed on the income from the sales of Product X and Product Y is 10%. Country A imposes an effective rate of tax on sales income of 20%. Country B imposes an effective rate of tax on sales income of 12%.

(ii) *Result.* Pursuant to this paragraph (b)(1)(ii)(c)(2), paragraph (b)(1)(ii)(b) of this section is separately applied to Branch A and Branch B with respect to the sales income of FS attributable to Product X (manufactured by Branch A) and Product Y (manufactured by Branch B). Because the effective rate of tax on FS's sales income from the sale of Product X in Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (20%), the use of Branch A has substantially the same tax effect as if Branch A were a wholly owned subsidiary corporation of FS. Because the effective rate of tax on FS's sales income from the sale of Product Y in Country M (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch B is located (12%), the use of Branch B does not have substantially the same tax effect as if Branch B were a wholly owned subsidiary corporation of FS. Consequently, only Branch A is treated as a separate corporation apart from the remainder of FS for purposes of determining foreign base company sales income.

(3) *Use of more than one manufacturing branch, or one or more manufactur-*

*ing branches and the remainder of the controlled foreign corporation, to manufacture, produce, construct, grow, or extract the same item of personal property—(a)—In general.* This paragraph (b)(1)(ii)(c)(3) applies to determine the location of manufacturing, producing, constructing, growing or extracting of personal property for purposes of applying paragraphs (b)(1)(i)(b) or (ii)(b) of this section where more than one branch of a controlled foreign corporation, or one or more branches of a controlled foreign corporation and the remainder of the controlled foreign corporation, each engage in manufacturing, producing, constructing, growing or extracting activities with respect to the same item of personal property which is then sold by the controlled foreign corporation.

(b) *Physical manufacture, production, or construction in one or more locations.* If only one branch or only the remainder of a controlled foreign corporation satisfies either paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to an item of personal property, then that branch or the remainder of the controlled foreign corporation will be the location of manufacturing, producing, or constructing of that property for purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section to the income from the sale of that property. See §1.954-3(b)(1)(ii)(c)(3)(f) *Example 1.* If more than one branch, or one or more branches and the remainder of the controlled foreign corporation, each independently satisfy either paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to an item of property, then the location of manufacturing, producing, or constructing of that property for purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section will be that branch or the remainder of the controlled foreign corporation that satisfies paragraph (a)(4)(ii) or (a)(4)(iii) of this section and that is located or organized in the jurisdiction that would, after applying paragraph (b)(1)(ii)(b) of this section to such branch or paragraph (b)(1)(i)(b) of this section to the remainder of the controlled foreign corporation, impose the lowest effective rate of tax on the income allocated to such branch or the remainder of the controlled foreign corporation under such paragraph (that is, either paragraph (b)(1)(ii)(b) or (b)(1)(i)(b) of this section), if, under the

laws of such country, the entire income of the controlled foreign corporation were considered derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country. See §1.954-3(b)(1)(ii)(c)(3)(f) *Example 2.*

(c) *Predominant contribution.* If none of the branches nor the remainder of a controlled foreign corporation satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to an item of personal property, but the controlled foreign corporation as a whole makes a substantial contribution to the manufacture, production, or construction of that property within the meaning of paragraph (a)(4)(iv) of this section, then for purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section, the branch or the remainder of the controlled foreign corporation that makes the predominant amount of the controlled foreign corporation's substantial contribution with respect to the manufacture, production, or construction of that property will be the location of manufacturing, producing, or constructing with respect to that property. See §1.954-3(b)(1)(ii)(c)(3)(f) *Example 3.* Whether any branch or the remainder of the controlled foreign corporation provides a predominant amount of the controlled foreign corporation's substantial contribution is determined by weighing each branch's or the remainder of the controlled foreign corporation's relative contribution to the manufacture of the item of property as determined by applying the facts and circumstances test provided in paragraph (a)(4)(iv) of this section. If multiple branches are located in a single jurisdiction, then the activities of those branches will be aggregated for purposes of determining the branch or the remainder of the controlled foreign corporation that makes the predominant amount of the controlled foreign corporation's substantial contribution with respect to the manufacture, production, or construction of an item of property. For purposes of this paragraph (b)(1)(ii)(c)(3)(c), a branch or the remainder of the controlled foreign corporation makes a predominant amount of the controlled foreign corporation's substantial contribution with respect to the

manufacture, production, or construction of an item of personal property only if it makes a significantly greater contribution to the manufacture, production, or construction of that property than any other branch or the remainder of the controlled foreign corporation.

(d) *Location of activity.* The location of any activity with respect to the manufacture, production, or construction of an item of personal property is where the controlled foreign corporation makes a contribution through its employees to such activity. For example, the location of any activities concerning intangible property is not determined based on the formal assignment of intangible property, but on where employees of the controlled foreign corporation develop, protect, and direct the use of the intangible.

(e) *Where no branch or the remainder of the controlled foreign corporation provides a predominant contribution.* If neither a branch nor the remainder of a controlled foreign corporation independently satisfies paragraph (a)(4)(ii) or (iii) of this section and neither a branch nor the remainder of the controlled foreign corporation provides a predominant amount of the controlled foreign corporation's contribution to the manufacture of an item of personal property, but the controlled foreign corporation as a whole makes a substantial contribution to the manufacture of that property within the meaning of paragraph (a)(4)(iv) of this section, then for purposes of applying paragraph (b)(1)(i)(b) or (ii)(b) of this section, the location of manufacturing of that property will be that branch or remainder of the controlled foreign corporation that provides a contribution to the manufacture of the property and that is located or organized in the jurisdiction that would, after applying paragraph (b)(1)(ii)(b) of this section to such branch or (b)(1)(i)(b) of this section to such remainder of the controlled foreign corporation, impose the highest effective rate of tax on the income allocated to such branch or such remainder of the controlled foreign corporation under that paragraph, if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by such corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such per-

manent establishment, and the corporation were created or organized under the laws of, and managed and controlled in, such country. See §1.954-3(b)(1)(ii)(c)(3)(f) *Example 4.*

(f) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(ii)(c)(3):

*Example 1. Multiple branches that contribute to the manufacture of a single product, only one branch that satisfies paragraph (a)(4)(ii) or (a)(4)(iii) of this section.* (i) *Facts.* FS is a controlled foreign corporation organized in Country M. FS operates three branches, Branch A, Branch B, and Branch C, located respectively in Country A, Country B, and Country C. Branch A, Branch B, and Branch C each performs different manufacturing activities with respect to the manufacture of Product X. Branch A, through the activities of its employees, designs Product X. Branch B, through the activities of its employees, provides quality control and oversight. Branch C, through the activities of its employees, manufactures Product X (within the meaning of paragraph (a)(4)(iii) of this section) using the designs of Branch A and under the oversight of the quality control personnel of Branch B. The activities of Branch A and Branch B do not satisfy either paragraph (a)(4)(ii) or (a)(4)(iii) of this section. Employees of FS located in Country M purchase the raw materials used in the manufacture of Product X from a related person and control the work-in-process and finished goods throughout the manufacturing process. Employees of FS located in Country M also manage the risk of loss from the manufacture of Product X and the manufacturing profits from the sales of Product X. Further, employees of FS located in Country M control logistics, select vendors and raw materials, and oversee the coordination between the branches. Employees of FS located in Country M sell Product X to unrelated persons for use, consumption or disposition outside of Country M. The sales income from the sale of Product X is taxed in Country M at an effective rate of tax of 10%. Country C imposes an effective rate of tax of 20% on sales income.

(ii) *Result.* Because only the activities of Branch C satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section, paragraph (b)(1)(ii)(b) of this section is applied by considering only the effective rate of tax that would apply in Country C. The effective rates of tax in Country A and Country B are not considered, because Branch A and Branch B do not satisfy either paragraph (a)(4)(ii) or (a)(4)(iii) of this section. Because the effective rate of tax on the sales income (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch C is located (20%), the use of Branch C has substantially the same tax effect as if Branch C were a wholly owned subsidiary corporation of FS. Therefore sales of Product X by the remainder of FS are treated as sales on behalf of Branch C. Pursuant to paragraph (b)(2)(ii)(c)(2) of this section, FS will only qualify for the manufacturing exception under paragraph (a)(4)(iv) of this section if FS successfully rebuts, to the satisfaction of the Commissioner, the presumption that FS does not provide a substantial contribution to the manufacture of Product X. For this purpose, the activities of FS include the activities

of Branch A or Branch B if either of those branches would not be treated as a separate corporation under paragraph (b)(1)(ii)(b) of this section, if that paragraph were applied to each of Branch A and Branch B.

*Example 2. Multiple branches satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to the same product sold by the controlled foreign corporation.* (i) *Facts.* Assume the same facts as in *Example 1*, except for the following. In addition to the design of Product X, Branch A also manufactures (within the meaning of paragraph (a)(4)(ii) of this section) a part of Product X. Branch C then combines that part with other parts to complete Product X. The activities of Branch C are sufficient to qualify as manufacturing under paragraph (a)(4)(iii) of this section with respect to Product X. Country A imposes an effective rate of tax of 12% on sales income.

(ii) *Result.* Because the activities of Branch A and Branch C satisfy the requirements of paragraph (a)(4)(ii) and (iii) of this section respectively, paragraph (b)(1)(ii)(b) of this section is applied by comparing the effective rate of tax imposed on the income from the sales of Product X against the lowest effective rate of tax that would apply to the sales income in either Country A or Country C if paragraph (b)(1)(ii)(b) of this section were applied separately to Branch A and Branch C. The effective rate of tax in Country B is not considered because Branch B does not satisfy either paragraph (a)(4)(ii) or (a)(4)(iii) of this section. Because the effective rate of tax on the sales income of FS from the sale of Product X (10%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the country in which Branch A is located (12%), neither Branch A nor Branch C is treated as a separate corporation and sales of Product X by the remainder of the controlled foreign corporation are not treated as made on behalf of any branch.

*Example 3. Predominant contribution by employees located in the country of organization of the controlled foreign corporation, traveling employees, paragraph (a)(4)(iii) of this section satisfied by an unrelated contract manufacturer.* (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation located in Country C that performs the physical conversion pursuant to a contract manufacturing arrangement. Employees of FS located in Country M sell Product X to unrelated persons for use, consumption or disposition outside of Country M. Employees of FS located in Country M engage in design, testing, quality control and oversight with respect to the manufacture of Product X. Employees of FS located in Country M also direct the use of intellectual property used in the manufacture of Product X from Country M. At all times, employees of FS located in Country M control the raw material, work-in-process and finished goods. Employees of FS located in Country M also control logistics, select vendors, and manage the risk of loss from the manufacture of Product X and the manufacturing profits from Product X. Quality control and oversight of the manufacturing process is conducted by employees of FS who are employed in Country M but who regularly travel to Country C. Branch A, located in Country A, is the only branch

of FS. Design work with respect to Product X conducted by Branch A is supplemental to the bulk of the design work, which is done by employees of FS located in Country M. FS as a whole (including Branch A) provides a substantial contribution to the manufacture of Product X within the meaning of paragraph (a)(4)(iv) of this section.

(ii) *Result.* FS qualifies for the exception to foreign base company sales income contained in paragraph (a)(4) of this section with respect to income from the sale of Product X because FS satisfies the test contained in paragraph (a)(4)(iv) of this section by providing a substantial contribution through the activities of its employees to the manufacture of Product X. The fact that employees of FS travel to the location of CM to perform some of the activities considered in determining whether a controlled foreign corporation makes a substantial contribution through the activities of its employees to the manufacturing of an item of personal property does not prevent activities of such employees while located in Country M from being considered in determining the applicability of paragraph (a)(4)(iv) of this section to FS. In addition, paragraph (b) of this section does not apply to treat a branch of FS as having substantially the same tax effect as if the branch were a wholly owned subsidiary corporation, because FS, as opposed to Branch A, provides the predominant contribution with respect to Product X.

*Example 4. Multiple branches perform manufacturing activities, no branch makes a predominant contribution, paragraph (a)(4)(iii) of this section is satisfied by an unrelated contract manufacturer.* (i) *Facts.* FS, a controlled foreign corporation organized in Country M, purchases raw materials from a related person. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM, an unrelated corporation located in Country C that performs the physical conversion pursuant to a contract manufacturing arrangement. Employees of FS located in Country M sell Product X to unrelated persons for use, consumption or disposition outside of Country M. FS has two branches, Branch A and Branch B, located in Country A and Country B respectively. FS (including Branch A and Branch B) makes a substantial contribution within the meaning of paragraph (a)(4)(iv) of this section with respect to the manufacture of Product X. Branch A, through the activities of its employees, designs Product X. Branch B, through the activities of its employees, provides quality control and oversight of the manufacturing process. At all times, FS controls the raw materials, work-in-process and the finished Product X through employees located in Country M. FS also manages the risk of loss related to the manufacture of Product X and the manufacturing profits from the sales of Product X through employees located in Country M. Further, employees of FS located in Country M control logistics, select vendors, and oversee the coordination between the branches. Country M imposes an effective rate of tax on sales income of 10%. Country A imposes an effective rate of tax on sales income of 20% and Country B imposes an effective rate of tax on sales income of 24%.

(ii) *Result.* Based on the facts, neither the remainder of FS (through activities of its employees in Country M), nor Branch A, nor Branch B, provide a predominant amount of the controlled foreign corpo-

ration's substantial contribution to the manufacture of Product X. FS, Branch A, and Branch B each provide a contribution through the activities of their employees to the manufacture of Product X. Accordingly, paragraph (b)(1)(ii)(b) of this section is applied by comparing the effective rate of tax imposed on the income from the sales of Product X against the effective rate of tax that would apply to the sales income in Branch B, which is located in the jurisdiction that would impose the highest effective rate of tax on the sales income (24%). Because the effective rate of tax imposed on the sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country B (24%) the remainder of FS is treated as selling on behalf of Branch B. Further, for purposes of determining whether the remainder of FS qualifies for any exception from foreign base company sales income, applying paragraph (b)(2)(ii)(a) of this section, the remainder of FS includes any branch of FS that would not, after the application of paragraph (b)(1)(ii)(b) of this section to such branch, be treated as a separate corporation. In this case, the effective rate of tax imposed on the sales income by Country M (10%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (20%). Therefore, for purposes of determining foreign base company sales income, the remainder of FS does not include the activities of Branch A. The remainder of FS must therefore independently qualify for the manufacturing exception contained in paragraph (a)(4) of this section or income from the sale of Product X will be foreign base company sales income.

*Example 5. Multiple branches contribute to the manufacture of a single product, one branch sells the product, the remainder of the controlled foreign corporation does not participate.* (i) *Facts.* FS is a controlled foreign corporation organized in Country M, a country that imposes a 0% effective rate of tax on sales income. FS operates two branches, Branch A and Branch B, located respectively in Country A, a country that imposes a 30% effective rate of tax on income, and Country B, a country that imposes a 0% effective rate of tax on income. Branch A and Branch B each perform different activities with respect to the manufacture of Product X. Branch A, through the activities of a large number of its employees working at a state of the art facility, expends significant time and resources to design a sophisticated product, Product X. Branch B, through the activities of its employees, purchases raw materials from a related person and contracts with CM, an unrelated corporation located in Country C, to manufacture Product X. The raw materials are then manufactured (under the principles of paragraph (a)(4)(iii) of this section) into Product X by CM. Branch A, through the activities of its employees, directs the use of intellectual property it developed, including product designs, to provide quality control and oversight to CM with respect to the manufacture of Product X. Branch B controls the raw materials, work in process, and the finished Product X. Branch B manages the risk of loss with respect to Product X throughout the manufacturing process. Branch B also controls logistics and selects vendors in connection with Product X. Branch B then sells Product X to unrelated persons for use, consumption or disposition outside of Country M. FS

(including Branch A and Branch B) provides a substantial contribution within the meaning of paragraph (a)(4)(iv) of this section with respect to the manufacture of Product X. FS does not provide a contribution to the manufacture of Product X through employees located in Country M.

(ii) *Result.* Based on the facts, neither Branch A nor Branch B provides the predominant amount of FS's contribution to the manufacture of Product X. Further, Branch A and Branch B each provide a contribution through the activities of its employees to the manufacture of Product X. Accordingly, pursuant to paragraph (b)(2)(ii)(c)(3)(e), Branch A is treated as the location of manufacturing for purposes of applying paragraph (b)(1)(ii)(b) of this section. Therefore, the effective rate of tax imposed on the income from the sales of Product X is compared against the effective rate of tax that would apply to that income if it were earned in Country A, which would impose the highest effective rate of tax on the sales income (30%). Because the effective rate of tax in Country B with respect to the sales income (0%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (30%), Branch B, treated as the remainder of FS pursuant to paragraph (b)(1)(ii)(c) of this section, is treated as selling on behalf of Branch A. Further, for purposes of determining whether the remainder of FS qualifies for any exception from foreign base company sales income, Branch B, treated as the remainder of FS, includes any branch or remainder of FS that would not, after the application of paragraph (b)(1)(ii)(b) of this section to such branch or (b)(1)(i)(b) of this section to such remainder of FS, be treated as a separate corporation. In this case, the effective rate of tax (0%) is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in Country A (30%), but not country M (0%). Therefore, for purposes of determining foreign base company sales income, Branch B, treated as the remainder of FS, does not include the activities of Branch A, but does include the activities of the remainder of FS located in Country M. However, since the remainder of FS in Country M does not perform any activities related to the manufacture of Product X, the inclusion of the remainder of FS does not qualify Branch B for any exception from foreign base company sales income. Branch B, treated as the remainder of FS, must therefore independently qualify for the manufacturing exception from foreign base company sales income contained in paragraph (a)(4) of this section or the income from the sale of Product X will be foreign base company sales income.

*Example 6. Multiple branches contribute to the manufacture of a single product, the selling branch is located in the higher tax jurisdiction, the remainder of the controlled foreign corporation does not participate.* (i) *Facts.* Assume the same facts as in Example 5 except that Branch B rather than Branch A is located in the jurisdiction that would impose the higher effective rate of tax on income from the sales of Product X.

(ii) *Result.* Based on the facts, neither Branch A nor Branch B provides the predominant amount of FS's contribution to the manufacture of Product X. Since Branch B is located in the jurisdiction that would impose the higher effective rate of tax on income from the sale of Product X, Branch B is consid-

ered to be the location of manufacturing of Product X for purposes of applying paragraph (b) of this section. Because all of the income from the sale of Product X is already taxed in Country B, the use of Branch B is not treated as having substantially the same tax effect as if Branch B were a wholly owned subsidiary corporation of FS, and therefore Branch B and the remainder of FS are not treated as separate corporations under paragraph (b)(1)(ii)(a) of this section for purposes of determining foreign base company sales income.

(2) \* \* \*

(i) \* \* \*

(b) *Activities treated as performed on behalf of the remainder of corporation.* With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will—

(1) With respect to personal property manufactured, produced, constructed, grown, or extracted by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation); or

(2) With respect to personal property (other than property described in paragraph (b)(2)(i)(b)(1) of this section) purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), be treated as performed on behalf of the remainder of the controlled foreign corporation.

(ii) \* \* \*

(a) *Treatment as separate corporations.*

\* \* \* For purposes of applying the rules of this paragraph (b)(2)(ii), a branch or similar establishment of a controlled foreign corporation treated as a separate corporation purchasing or selling on behalf of the remainder of the controlled foreign corporation under paragraph (b)(2)(ii)(b) of this section, or the remainder of the controlled foreign corporation treated as a separate corporation purchasing or selling on behalf of a branch or similar establishment of the controlled foreign corporation under paragraph (b)(2)(ii)(c) of this section, will exclude any other branch or similar establishment or remainder of the controlled foreign corporation that would be treated as a separate corporation (apart from the branch or similar establishment of a controlled foreign corporation that is treated as a separate purchasing or selling corporation under paragraph (b)(2)(ii)(b) of this section or the remainder of the con-

trolled foreign corporation that is treated as a separate purchasing or selling corporation under paragraph (b)(2)(ii)(c) of this section) if the effective rate of tax imposed on the income of the purchasing or selling branch or similar establishment, or purchasing or selling remainder of the controlled foreign corporation, were tested under the principles of §1.954-3(b)(1)(i)(b) or (ii)(b) of this section against the effective rate of tax that would apply to such income if it were earned in the jurisdiction of such other branch or similar establishment or the remainder of the controlled foreign corporation.

(b) *Activities treated as performed on behalf of the remainder of corporation.* With respect to purchasing or selling activities performed by or through the branch or similar establishment, such purchasing or selling activities will—

(1) With respect to personal property manufactured, produced, constructed, grown, or extracted by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation); or

(2) With respect to personal property (other than property described in paragraph (b)(2)(ii)(b)(1) of this section) purchased or sold, or purchased and sold, by the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), be treated as performed on behalf of the remainder of the controlled foreign corporation.

(c) *Treatment of the use of a manufacturing branch by a controlled foreign corporation—(1) Activities treated as performed on behalf of branch.* \* \* \*

(2) *Presumption where a controlled foreign corporation claims to satisfy the substantial contribution test and its own branch satisfies the physical manufacturing test.* If a branch or similar establishment is considered to manufacture, produce, or construct an item of personal property under paragraph (a)(4)(ii) or (a)(4)(iii) of this section, the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation) will be presumed not to manufacture, produce, or construct that same item of personal property under paragraph (a)(4)(iv) of this section (even if it would have otherwise satisfied paragraph (a)(4)(iv) of this

section with respect to such property). However, if a controlled foreign corporation demonstrates, to the satisfaction of the Commissioner, that the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation) makes a substantial contribution to the manufacture of that item of personal property within the meaning of paragraph (a)(4)(iv) of this section, then the remainder of the controlled foreign corporation (or any branch treated as the remainder of the controlled foreign corporation), if treated as a separate corporation apart from its manufacturing branch under paragraph (b)(2)(ii)(a) of this section, will be considered to manufacture, produce, or construct that item of personal property under paragraph (a)(4)(iv) of this section. The application of this paragraph (b)(2)(ii)(c)(2) may be illustrated by the following examples:

*Example 1. Manufacturing branch, paragraph (b)(1)(ii)(b) satisfied.* (i) *Facts.* FS, a controlled foreign corporation organized in Country M, a country that imposes a 0% effective rate of tax on sales income, purchases raw materials from a related person. FS has one branch, Branch A, organized in Country A, a country that imposes a 30% effective rate of tax on sales income. The raw materials are manufactured (within the meaning of paragraph (a)(4)(iii) of this section) into Product X by Branch A. FS sells Product X for use, consumption, or disposition outside of Country M. Absent the application of paragraph (b)(2)(ii)(c)(2) of this section, the remainder of FS would also be considered a manufacturer of Product X under paragraph (a)(4)(iv) of this section. FS proves to the satisfaction of the Commissioner that the remainder of FS makes a substantial contribution to the manufacture of Product X.

(ii) *Result.* Since the effective rate of tax (0%) imposed on the sales income is less than 90%, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the jurisdiction of Branch A (30%), the remainder of FS is treated as a separate corporation selling on behalf of Branch A. The remainder of FS (not including Branch A) does not satisfy paragraph (a)(4)(ii) or (a)(4)(iii) of this section with respect to Product X. If the manufacturing activities undertaken with respect to Product X between the time the raw materials were purchased and the time Product X was sold were undertaken by the remainder of FS (not including Branch A) through the activities of its employees, the remainder of FS would have satisfied the manufacturing exception contained in paragraph (a)(4)(iii) of this section with respect to Product X. Therefore, paragraph (a)(4)(iv) of this section applies. Because FS has successfully rebutted the presumption of paragraph (b)(2)(ii)(c)(2) of this section by proving to the satisfaction of the Commissioner that the remainder of FS makes a substantial contribution to the manufacture (within the meaning of paragraph (a)(4)(iv) of this section) of Product X, it qualifies for the ex-



ception in paragraph (a)(4)(iv) of this section with respect to Product X. Therefore income from the sale of Product X, when treated as sold by the remainder of FS on behalf of Branch A, is not determined to be foreign base company sales income.

*Example 2. Manufacturing branch, paragraph (b)(1)(ii)(b) is not satisfied.* (i) *Facts.* Assume the same facts as in *Example 1*, except that Branch A is located in Country B, a country that imposes a 3% rate of tax on sales income.

(ii) *Result.* Paragraph (b)(1)(ii)(b) of this section is not satisfied, because the effective rate of tax imposed on the sales income in Country M (0%) is not less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply to such income in the jurisdiction of Branch A (3%). Therefore, Branch A is not treated as a separate corporation for purposes of determining foreign base company sales income. FS qualifies for the manufacturing exception in paragraph (a)(4) of this section because FS (including Branch A) satisfies paragraph (a)(4)(iii) of this section with respect to income from the sales of Product X.

\* \* \* \* \*

(e) *Comparison with ordinary treatment.* With the exception of cases in which a controlled foreign corporation seeks to rely on paragraph (a)(4)(iv) of this section and is unsuccessful in rebutting the presumption created by paragraph (b)(2)(ii)(c)(2) of this section, income derived by a branch or similar establishment, or by the remainder of the controlled foreign corporation, will not be determined to be foreign base company sales income under paragraph (b) of this section if the income would not be so considered if it were derived by a separate controlled foreign corporation under like circumstances.

\* \* \* \* \*

(4) \* \* \*

*Example 3. (i) Facts.* Corporation E, a controlled foreign corporation incorporated under the laws of foreign Country X, is a wholly owned subsidiary of Corporation D, also a controlled foreign corporation incorporated under the laws of Country X. Corporation E maintains Branch B in foreign Country Y. Both corporations use the calendar year as the taxable year. In 1964, Corporation E's sole activity, carried on through Branch B, consists of the purchase of articles manufactured in Country X by Corporation D, a related person, and the sale of the articles through Branch B to unrelated persons. One hundred percent of the articles sold through Branch B are sold for use outside Country X and 90 percent are also sold for use outside of Country Y. The income of Corporation E derived by Branch B from such transactions is taxed to Corporation E by Country X only at the time Corporation E distributes such income to Corporation D and is then taxed on the basis of what the tax (a 40 percent effective rate) would have been if the income had been derived in 1964 by Corporation E from sources within Country X from doing business through a permanent establishment therein. Country Y levies an income tax at an effective rate of 50 percent on in-

come derived from sources within such country, but the income of Branch B for 1964 is effectively taxed by Country Y at a 5 percent rate since under the laws of such country, only 10 percent of Branch B's income is derived from sources within such country. Corporation E makes no distributions to Corporation D in 1964.

(ii) *Result.* In determining foreign base company sales income of Corporation E for 1964, Branch B is treated as a separate wholly owned subsidiary corporation of Corporation E, the 5 percent rate of tax being less than 90 percent of, and at least 5 percentage points less than the 40 percent rate. Income derived by Branch B, treated as a separate corporation, from the purchase from a related person (Corporation D), of personal property manufactured outside of Country Y and sold for use, disposition, or consumption outside of Country Y constitutes foreign base company sales income. If, instead, Corporation D were unrelated to Corporation E, none of the income would be foreign base company sales income because Corporation E would be purchasing from and selling to unrelated persons and if Branch B were treated as a separate corporation it would likewise be purchasing from and selling to unrelated persons. Alternatively, if Corporation D were related to Corporation E, but Branch B manufactured the articles prior to sale under the principles of paragraph (a)(4)(iv) of this section in conjunction with the manufacture of the articles (within the meaning of paragraph (a)(4)(ii) or (a)(4)(iii) of this section) by an unrelated contract manufacturer, then the income would not be foreign base company sales income because Branch B, treated as a separate corporation, would qualify for the manufacturing exception under paragraph (a)(4)(i) of this section.

\* \* \* \* \*

(d) *Effective/applicability date.* The second sentence of paragraph (a)(1)(i), the second sentence of paragraph (a)(1)(iii) *Example 1*, the first sentence of paragraph (a)(1)(iii) *Example 2*, the third sentence of paragraph (a)(2), paragraph (a)(4)(i), the first sentence of paragraph (a)(4)(ii), the first sentence of paragraph (a)(4)(iii), paragraph (a)(4)(iv), paragraph (a)(6)(i), the last sentence of paragraph (b)(1)(ii)(a), paragraph (b)(1)(ii)(c)(2), paragraph (b)(1)(ii)(c)(3), paragraph (b)(2)(i)(b), the last sentence of paragraph (b)(2)(ii)(a), paragraph (b)(2)(ii)(b), paragraph (b)(2)(ii)(c)(2), paragraph (b)(2)(ii)(e), and paragraph (b)(4) *Example 3* shall apply to taxable years of controlled foreign corporations beginning on or after the date these rules are published as final regulations in the **Federal Register**, and for taxable years of United States shareholders in which or with which such taxable years of the controlled foreign corporations end.

Linda E. Stiff,  
*Deputy Commissioner for  
Services and Enforcement.*

(Filed by the Office of the Federal Register on February 27, 2008, 8:45 a.m., and published in the issue of the Federal Register for February 28, 2008, 73 F.R. 10716)

## Notice of Proposed Rulemaking

### Multiemployer Plan Funding Guidance

REG-151135-07

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations under section 432 of the Internal Revenue Code (Code). These proposed regulations provide additional rules for certain multiemployer defined benefit plans that are in effect on July 16, 2006. These proposed regulations affect sponsors and administrators of, and participants in multiemployer plans that are in either endangered or critical status. These regulations are necessary to implement the new rules set forth in section 432 that are effective for plan years beginning after 2007. The proposed regulations reflect changes made by the Pension Protection Act of 2006.

**DATES:** Written or electronic comments and requests for public hearing must be received by June 16, 2008.

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-151135-07), 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-151135-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-151135-07).



FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Bruce Perlin, (202) 622-6090; concerning submissions and requests for a public hearing, *Richard.A.Hurst@irscounsel.treas.gov* or at (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

#### Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by May 19, 2008.

Comments are specifically requested concerning:

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

The accuracy of the estimated burden associated with the collection of information;

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

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

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

The collection of information in this regulation is in §1.432(b)-1(d) and (e). This information is required in order for a qualified multiemployer defined benefit

plan's enrolled actuary to provide a timely certification of the plan's funding status. In addition, if it is certified that a plan is or will be in critical or endangered status, the plan sponsor is required to notify the Department of Labor, the Pension Benefit Guaranty Corporation, the bargaining parties, participants, and beneficiaries of the status designation. For plans in critical status, the plan sponsor is required to include in the notice an explanation of the possibility that adjustable benefits may be reduced at a later date and that certain benefits are restricted as of the date the notice is sent. The annual certification by the enrolled actuary for the plan will be used to provide an accurate determination and certification of the plan's funded status and to provide notice to the required parties of the status designation. The collection of information is mandatory. The likely respondents are multiemployer plan sponsors and enrolled actuaries.

Estimated total annual reporting burden: 1,200 hours.

Estimated average annual burden hours per respondent: 0.75 hours.

Estimated number of respondents: 1,600.

Estimated annual frequency of responses: occasional.

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

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

#### Background

This document contains proposed Income Tax Regulations (26 CFR part 1) under section 432, as added to the Internal Revenue Code by the Pension Protection Act of 2006 (PPA '06), Public Law 109-280, 120 Stat 780.

Section 412 contains minimum funding rules that generally apply to pension

plans. Section 431 sets forth the funding rules that apply specifically to multiemployer defined benefit plans. Section 432 sets forth additional rules that apply to multiemployer plans in effect on July 16, 2006, that are in endangered or critical status<sup>1</sup>.

Section 432 generally provides for a determination by the enrolled actuary for a multiemployer plan as to whether the plan is in endangered status or in critical status for a plan year. In the first year that the actuary certifies that the plan is in endangered status, section 432(a)(1) requires that the plan sponsor adopt a funding improvement plan. The funding improvement plan must meet the requirements of section 432(c) and the plan must apply the rules of section 432(d) during the period that begins when the plan is certified to be in endangered status and ends when the plan is no longer in that status. In the first year that the actuary certifies that the plan is in critical status, section 432(a)(2) requires that the plan sponsor adopt a rehabilitation plan. The rehabilitation plan must meet the requirements of section 432(e) and the plan must apply the rules of section 432(f) during the period that begins when the plan is certified to be in critical status and ends when the plan is no longer in that status. In addition, section 432(f)(2) requires that the plan suspend certain actions as described more fully in this preamble.

Section 432(b)(3)(A) requires an actuarial certification of whether or not a multiemployer plan is in endangered status, and whether or not a multiemployer plan is or will be in critical status, for each plan year. This certification must be completed by the 90th day of the plan year and must be provided to the Secretary of the Treasury and to the plan sponsor. If the certification is with respect to a plan year that is within the plan's funding improvement period or rehabilitation period arising from a prior certification of endangered or critical status, the actuary must also certify whether or not the plan is making scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan. Failure of the plan's actuary to certify the status of the plan is

<sup>1</sup> Section 302 and section 304 of the Employee Retirement Income Security Act of 1974, as amended (ERISA) sets forth funding rules that are parallel to those in section 412 and section 431 of the Code. Section 305 of ERISA sets forth additional rules for multiemployer plans that are parallel to those in section 432 of the Code. Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713) and section 302 of ERISA, the Secretary of the Treasury has interpretive jurisdiction over the subject matter addressed in these proposed regulations for purposes of ERISA, as well as the Code. Thus, these Treasury Department regulations issued under section 432 of the Code apply as well for purposes of ERISA section 305.

treated as a failure to file the annual report under section 502(c)(2) of the Employee Retirement Income Security Act of 1974 (ERISA). Thus, a penalty of up to \$1,100 per day applies.

Under section 432(b)(1), a multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year, (1) the plan's funded percentage for the plan year is less than 80 percent, or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions under section 431(d)). Under section 432(i), a plan's funded percentage is the percentage determined by dividing the value of the plan's assets by the accrued liability of the plan.

Under section 432(b)(2), a multiemployer plan is in critical status for a plan year if it meets any of four specified tests. Under section 432(b)(2)(A), a plan is in critical status if, as of the beginning of the plan year: (1) the funded percentage of the plan is less than 65 percent and (2) the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer contributions for the current plan year and each of the six succeeding plan years is less than the present value of all nonforfeitable benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses). For this purpose, employer contributions are determined assuming that the terms of all collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years.

Under section 432(b)(2)(B), a plan is in critical status if the plan has an accumulated funding deficiency for the current plan year or is projected to have an accumulated funding deficiency for any of the three succeeding plan years. For purposes of this test, the determination of accumulated funding deficiency is made not taking into account any amortization extension under section 431(d). In addition, if a plan has a funded percentage of 65 percent or less, the three-year period for projecting whether the plan will have an accumulated funding deficiency is extended to four years.

Under section 432(b)(2)(C), a plan is in critical status for the plan year if (1) the plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding year, exceeds the present value of the reasonably anticipated employer and employee contributions for the current plan year, (2) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and (3) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions under section 431(d)).

Under section 432(b)(2)(D), a plan is in critical status for a plan year if the sum of (A) the market value of plan assets, and (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses). For this purpose, employer contributions are determined assuming that the terms of all collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years.

In making the determinations and projections applicable under the endangered and critical status rules, the plan actuary must make projections for the current and succeeding plan years of the current value of the assets of the plan and the present value of all liabilities to participants and beneficiaries under the plan for the current plan year as of the beginning of such year. The actuary's projections must be based on reasonable actuarial estimates, assumptions, and methods that offer the actuary's best estimate of anticipated experience under the plan. An exception to this rule applies in the case of projected industry activity. Any projection of activity in the industry or industries covered by the plan, including future covered employment and contribution levels, must be based on information provided by the plan sponsor, and the plan sponsor must act reasonably

and in good faith. The projected present value of liabilities as of the beginning of the year must be based on either the most recent actuarial statement required with respect to the most recently filed annual report or the actuarial valuation for the preceding plan year.

Under section 432(b)(3)(B)(ii), any actuarial projection of plan assets must assume (1) reasonably anticipated employer contributions for the current and succeeding plan years, assuming that the terms of one or more collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for the succeeding plan years, or (2) that employer contributions for the most recent plan year will continue indefinitely, but only if the plan actuary determines that there have been no significant demographic changes that would make continued application of such terms unreasonable.

The first year that an actuary certifies that a plan is in endangered or critical status establishes a timetable for a number of actions. Under section 432(b)(3)(D), within 30 days after the date of certification, the plan sponsor must notify the participants and beneficiaries, the bargaining parties, the PBGC and the Secretary of Labor of the plan's endangered or critical status. If it is certified that a plan is or will be in critical status, the plan sponsor must include in the notice an explanation of the possibility that (1) adjustable benefits (as defined in section 432(e)(8)) may be reduced and (2) such reductions may apply to participants and beneficiaries whose benefit commencement date is on or after the date such notice is provided for the first plan year in which the plan is in critical status.

If a plan is certified to be in critical status, the plan must take certain actions after notifying the plan participants of the critical status. Specifically, section 432(f)(2) restricts the payment of benefits that are in excess of a single life annuity (plus any social security supplement) effective on the date the notice is sent. Section 432(f)(2)(B) provides that this restriction does not apply to amounts that may be immediately distributed without the consent of the employee under section 411(a)(11) and to any makeup payment in the case of a retroactive annuity starting date or a similar payment of benefits owed with re-

spect to a prior period. In addition, the plan sponsor must refrain from making any payment for the purchase of an irrevocable commitment from an insurer to pay benefits.

Sections 432(c)(1) and 432(e)(1) provide that in the first year that a plan is certified to be in endangered or critical status, the plan sponsor must adopt a funding improvement plan (in the case of a plan that is in endangered status) or a rehabilitation plan (in the case of a plan that is in critical status). The deadline for adoption of the funding improvement plan or rehabilitation plan is 240 days after the deadline for the certification. Accordingly, if the actuarial certification is made after the 90-day deadline, the amount of time for adopting the funding improvement plan or rehabilitation plan is shortened.

Section 432(c)(3) defines a funding improvement plan as a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements. Those requirements are based on a statutorily specified improvement in the plan's funding percentage from the percentage that applied on the first day of the funding improvement period. The first day of the funding improvement period is defined in section 432(c)(4) as the first day of the first plan year beginning after the earlier of (1) the second anniversary of the date of the adoption of the funding improvement plan or (2) the expiration of the collective bargaining agreements in effect on the due date for the actuarial certification of endangered status for the initial endangered year and covering, as of such due date, at least 75 percent of the active participants in such multiemployer plan.

Section 432(d)(1) sets forth rules that apply after the certification of endangered status and before the first day of the funding improvement period. After the adoption of the funding improvement plan, section 432(d)(2) prohibits any amendments that are inconsistent with the funding improvement plan. In addition, section 432(d)(2) provides special rules for acceptance of collective bargaining agreements and plan amendments that increase benefits.

A rehabilitation plan is a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements. Generally, the rehabilitation plan should enable the plan to emerge from critical status by the end of a 10-year period that begins after the earlier of (1) the second anniversary of the date of the adoption of the rehabilitation plan or (2) the expiration of the collective bargaining agreements in effect on the due date for the actuarial certification of critical status for the initial critical year and covering, as of such due date, at least 75 percent of the active participants in such multiemployer plan. For this purpose a plan emerges from critical status when the plan actuary certifies that the plan is not projected to have an accumulated funding deficiency for the plan year or any of the nine succeeding plan years, without regard to the use of the shortfall method and taking into account amortization period extensions under section 431(d). As an alternative, if the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the 10-year period, the requirements for a rehabilitation plan are that the plan include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency (within the meaning of section 4245 of ERISA).

Section 432(e)(8) allows a rehabilitation plan for a plan that is in critical status to provide for a reduction of certain "adjustable" benefits that would otherwise be protected by section 411(d)(6). These adjustable benefits include early retirement benefits and retirement-type subsidies within the meaning of section 411(d)(6)(B)(i). Under section 432(e)(8)(A)(ii), no reduction will apply to a participant whose benefit commencement date is before the date the notice under section 432(b)(3)(D) for the initial critical year is provided. Under section 432(e)(8)(B), except with respect to certain benefit increases described in section 432(e)(8)(A)(iv)(III), a plan is not permitted to reduce the level of a participant's ac-

crued benefit payable at normal retirement age. Furthermore, section 432(e)(8)(C) prohibits any reduction until 30 days after plan participants and beneficiaries, employers and employee organizations are notified of the reduction.

In years after the initial critical year or initial endangered year, sections 432(c)(6) and 432(e)(3)(B) provide that the plan sponsor must annually update the funding improvement or rehabilitation plan. This includes updating the schedule of contribution rates. Updates are required to be filed with the plan's annual report.

Section 432(f)(4) sets forth rules that apply after the certification of critical status and before the first day of the rehabilitation period. After the adoption of the rehabilitation plan, section 432(f)(1) prohibits any amendments that are inconsistent with the rehabilitation plan.

Section 432(h) provides rules for the treatment of employees who participate in the plan even though they are not covered by a collective bargaining agreement.

Section 432(i) provides a number of definitions that apply for purposes of section 432. For example, under section 432(i)(8), the actuary's determination with respect to a plan's normal cost, actuarial accrued liability, and improvements in a plan's funded percentage must be based on the unit credit funding method (whether or not that method is used for the plan's actuarial valuation).

Section 432 is effective for plan years beginning on or after January 1, 2008. Section 212(e)(2) of PPA '06 provides a special rule permitting a plan to provide the notice described in section 432(b)(3)(D) on an early basis. Specifically, if the plan actuary certifies that the plan is reasonably expected to be in critical status for the first plan year beginning after 2007, the plan is permitted to provide the notice described in section 432(b)(3)(D) at any time between the enactment of PPA '06 and the date the notice is otherwise required to be provided.

## Explanation of Provisions

### Overview

These regulations provide guidance with respect to certain of the provisions of section 432. Specifically, these regulations provide guidance regarding the

determination of when a plan is in endangered status or critical status and the associated notices. These regulations do not provide guidance with respect to all issues relating to a multiemployer plan that is in endangered or critical status. For example, no guidance is provided on the parameters for the adoption of a funding improvement plan or rehabilitation plan. Guidance with respect to additional issues will be included in a second set of regulations that are expected to be issued this year.

*§1.432(a)-1 General rules relating to section 432*

Section 1.432(a)-1 provides general rules relating to section 432, including definitions of certain terms used for purposes of section 432 and the special rules that apply to participants in multiemployer plans who are not participating pursuant to a collective bargaining agreement.

The regulations provide that effective on the date that a notice of critical status for the initial critical year is sent to the plan participants, the plan must not pay any benefit in excess of the monthly amount paid under a single life annuity (plus any social security supplement) and is not permitted to purchase an irrevocable commitment from an insurer to pay benefits. The restriction does not apply to the small-dollar cash-outs allowed under section 411(a)(11) nor to the make-up payments under a retroactive annuity starting date.

The regulations provide that if the notice described in section 432(b)(3)(D) has been sent and the restrictions provided under section 432(f)(2) have been applied, and it is later determined that the restrictions should not have been applied, then the plan must correct any benefit payments that were restricted in error. The regulations provide two examples of situations requiring this correction, each of which involves an actuary certifying that the plan is reasonably expected to be in critical status for the first plan year beginning after 2007, followed by an early notification of critical status that is made to employees under the rules of section 212(e)(2) of PPA '06. In one example of a plan taking actions that require correction, the plan restricts benefits before the first plan year beginning after 2007 (the effective date of sec-

tion 432). In the second such example, the plan is not in critical status for the first plan year beginning after 2007 (even though the enrolled actuary for the plan had certified that it is reasonably expected that the plan will be in critical status with respect to that year).

The regulations incorporate a number of definitions listed in section 432(i) along with other definitions that are located in sections 432(c) and (e). The regulations do not include the broad provision under section 432(i)(8) to use the unit credit funding method for purposes of the plan's "normal cost, actuarial accrued liability, and improvements in a plan's funded percentage." Instead, consistent with the intended scope of section 432(i)(8), the regulations require the use of this funding method solely for purposes of determining a plan's funded percentage and the section 432(b)(2)(C)(i) comparison of contributions with the sum of the plan's normal cost and interest on the amount of unfunded liability. Thus, the determination of whether a plan is projected to have an accumulated funding deficiency in the determination of a plan's status under section 432 is based on the plan's actual funding method, rather than the unit credit funding method. The regulations substitute the term "initial endangered year" for the statutory term "initial determination year."

In addition, the regulations provide guidance for plans that change their status in subsequent years. For example, a plan that is in critical status may emerge from that status and later reenter critical status. In such a circumstance, the year of reentry into critical status is treated as the initial critical year. Similarly, a plan that is in endangered status may have a status change and at a later date reenter endangered status. In such a circumstance, the year of reentry into endangered status is treated as the initial endangered year.

*§1.432(b)-1 Determination of status and adoption of a plan*

The regulations provide rules for the determination of whether a plan is in endangered status or critical status within the meaning of section 432(b)(1) and (2). These rules reflect the different ways a plan can be in endangered status under section 432(b)(1)(A) or (B) and in critical status under section 432(b)(2)(A), (B), (C),

or (D). The regulations also provide that a plan is in critical status for a plan year if it was in critical status in the immediately preceding year and the plan does not meet the emergence from critical status rule of section 432(e)(4)(B). Thus, a plan that was in critical status for the prior year will remain in critical status if the enrolled actuary for the plan certifies that the plan is projected to have an accumulated funding deficiency for the plan year or any of the 9 succeeding plan years, without regard to the use of the shortfall funding method, but taking into account any extensions of the amortization periods under section 431(d).

The regulations provide limited guidance on the actuarial projections that are used for purposes of the certification of status by the enrolled actuary for the plan. The projections must generally be based on reasonable actuarial assumptions and methods that, as under section 431(c)(3), offer the actuary's best estimate of anticipated experience under the plan. The actuarial projection of future contributions and assets must assume either that the terms of the one or more collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years, or that the dollar amount of employer contributions for the most recent plan year will continue indefinitely. If the actuarial projections assume the continued maintenance of the collective bargaining agreements, the plan sponsor must provide a projection of activity in the industry, including future covered employment, to the plan actuary, and the actuary is permitted to rely on those projections. In making these projections, the plan sponsor must act reasonably and in good faith. The alternative assumption that the dollar amount of contributions remains unchanged into the future is only available if the enrolled actuary for the plan determines there have been no significant demographic changes that would make such assumption unreasonable. In addition, the regulations provide that the alternative assumption is not available for purposes of determining whether the plan is in critical status under the tests in section 432(b)(2)(A) and (D).

The projected present value of liabilities as of the beginning of such year is determined based on the most recent information reported on the most recent of either the actuarial statement required un-

der section 103(d) of ERISA that has been filed with respect to the most recent year, or the actuarial valuation for the preceding plan year.

The regulations provide that, for purposes of section 432, if the plan received an extension of any amortization period under section 412(e), the extension is treated the same as an extension under section 431(d). Thus, such an extension is taken into account in determining endangered status under section 432(b)(1)(B) and emergence from critical status under section 432(e)(4)(B). In contrast, such an extension is not taken into account in determining whether a plan has or will have an accumulated funding deficiency for purposes of determining critical status under section 432(b)(2)(B) and (C).

The regulations describe the content of the annual certification required under section 432(b)(3) that must be sent to the plan sponsor and the IRS. The annual certification must be provided regardless of whether the plan is in endangered or critical status. If the plan is certified to be in endangered or critical status, then the certification must identify the plan, the plan sponsor, and the enrolled actuary who signs the certification; provide contact information for the plan sponsor and actuary; state whether or not the plan is in endangered or critical status for the plan year; and, if the certification is for a year other than the initial endangered year or the initial critical year, whether the plan is making the scheduled progress described in the plan's funding improvement plan or rehabilitation plan. The regulations also provide an IRS address to which the certification is to be mailed.

The regulations also provide that the content of the annual certification and the IRS address to which it is mailed may be added to or modified in guidance of general applicability to be published in the Internal Revenue Bulletin. Such additional information may include, for instance, which endangered status or critical status standard(s) applies to the plan; supporting information for the classification; a description of the actuarial assumptions used in making the certification; and a projection of the plan's funded percent-

age for future years. The guidance may also require additional supporting information for certifications made prior to the issuance of the guidance.

The regulations provide guidance on the notice required under section 432(b)(3)(D).<sup>2</sup> In particular the regulations require that, in the case of a plan that is in critical status and which provides for benefits that would be restricted under section 432(f)(2), the notice for the initial critical year must tell participants about the restriction. A plan sponsor that sends the model notice provided by the Secretary of Labor pursuant to section 432(b)(3)(D)(iii) satisfies this requirement.

If a section 432(b)(3)(D) notice for such a plan was sent prior to the deadline in that section and the notice did not contain the disclosure regarding the immediate restriction on benefits under section 432(f)(2), then the regulations provide that the notice does not satisfy the requirements for notice under section 432(b)(3)(D). Accordingly, the restrictions under section 432(f)(2) do not apply as a result of the issuance of such a notice and the plan will not be treated as having issued the notice for purposes of the section 432(e)(8)(A)(ii) restriction on reducing adjustable benefits for participants whose benefit commencement dates are prior to the issuance of that notice. However, if additional notice that includes all of the information required under the regulations is provided prior to the required date for notice for the initial critical year under section 432(b)(3)(D) (that is, 30 days after the certification for the plan year), then the notice requirements of section 432(b)(3)(D) are satisfied as of the date of the later notice. In such a case, if the earlier notice contained the information described in section 432(b)(3)(D)(ii), then the date of that earlier notice will apply for purposes of the section 432(e)(8)(A)(ii) restriction.

The regulations reflect the rules of section 212(e)(2) of PPA under which a plan sponsor is permitted to send an early notice to plan participants. This early notice, which applies solely to the first plan year beginning after 2007, is only available if

the plan actuary certifies to the plan sponsor that the plan is reasonably expected to be in critical status for that initial plan year. This preliminary certification that the plan is reasonably expected to be in critical status is different from the annual certification that the plan actuary must make; accordingly, the plan actuary must still certify whether the plan is in critical or endangered status (or in neither critical nor endangered status) for that plan year by the normal 90-day deadline for the certification.

### *Proposed legislation*

As of the date of the issuance of these proposed regulations, bills have been introduced in the House of Representatives and the Senate that would exclude from the section 432(f)(2) limitation on accelerated benefits a distribution with an annuity starting date that is before the date that the notice under section 432(b)(3)(D) is provided.<sup>3</sup> Section 1.432(a)-1(a)(3)(iii)(C) has been reserved in order to accommodate any enacted changes.

### **Effective/Applicability Dates**

These regulations apply to plan years ending after March 18, 2008, but only with respect to plan years that begin on or after January 1, 2008. These regulations do not address the sunset provision provided by PPA '06 section 221(c).

### **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. It is hereby certified that the collection of information imposed by these proposed regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. The estimated burden imposed by the collection of information contained in these proposed

<sup>2</sup> Under section 432(b)(3)(D)(ii), the Secretary of Labor is to prescribe a model notice that a multiemployer plan may use to satisfy this notice requirement.

<sup>3</sup> See H.R. 3361 (August 3, 2007) and S. 1974 (August 2, 2007) at sections 3(b)(1)(E) and 3(b)(2)(E)(ii). However, S. 1974, as amended and passed by the Senate on December 19, 2007, did not include this provision.

regulations is 0.75 hours per respondent. Moreover, most of this burden is attributable to the requirement for a qualified multiemployer defined benefit plan's enrolled actuary to provide a timely certification of the plan's funding status. In addition, if a plan is certified that it is or will be in critical or endangered status, the plan sponsor is required to notify the Department of Labor, the Pension Benefit Guaranty Corporation, the bargaining parties, participants, and beneficiaries of the status designation. For plans in critical status, the plan sponsor is required to include an explanation of the possibility that adjustable benefits may be reduced and that certain benefits are restricted as of the date the notice is sent. Pursuant to section 7805(f) of the Internal Revenue Code, this regulations has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (one signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department 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 will be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the public hearing will be published in the **Federal Register**.

### Drafting Information

The principal author of this regulation is Bruce Perlin, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

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### Proposed Amendments to the Regulations

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

#### PART 1—INCOME TAXES

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

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

Par. 2. Section 1.432(a)–1 is added to read as follows:

#### §1.432(a)–1 General rules relating to section 432.

(a) *In general*—(1) *Overview*. This section provides rules relating to multiemployer plans (within the meaning of section 414(f)) that are in endangered status or critical status under section 432. Section 432 and this section only apply to multiemployer plans that are in effect on July 16, 2006. Paragraph (b) of this section sets forth definitions of terms that apply for purposes of section 432. Paragraph (c) of this section sets forth special rules for plans described in section 404(c) and for the treatment of nonbargained participation.

(2) *Plans in endangered status*—(i) *Plan sponsor must adopt funding improvement plan*. If a plan is in endangered status, the plan sponsor must adopt and implement a funding improvement plan that satisfies the requirements of section 432(c).

(ii) *Restrictions applicable to plans in endangered status*. If a plan is in endangered status, the plan and plan sponsor must satisfy the requirements of section 432(d)(1) during the funding plan adoption period specified in section 432(c)(8).

(iii) *Restrictions applicable after the adoption of funding improvement plan*. In the case of a plan that is in endangered status after adoption of the funding improvement plan, the plan and the plan sponsor must satisfy the requirements of section 432(d)(2) until the end of the funding improvement period.

(3) *Plans in critical status*—(i) *Plan sponsor must adopt rehabilitation plan*. If a plan is in critical status, the plan sponsor must adopt and implement a rehabilitation plan that satisfies the requirements of section 432(e).

(ii) *Restrictions applicable to plans in critical status*. If a plan is in critical status, the plan and the plan sponsor must satisfy the requirements of section 432(f)(4) during the rehabilitation plan adoption period as defined in section 432(e)(5). The plan must also apply the restrictions on single sum and other accelerated benefits set forth in paragraph (a)(3)(iii) of this section.

(iii) *Restrictions on single sums and other accelerated benefits*—(A) *In general*. A plan in critical status is required to provide that, effective on the date the notice of certification of the plan's critical status for the initial critical year under §1.432(b)–1(e) is sent, no payment in excess of the monthly amount payable under a single life annuity (plus any social security supplements described in the last sentence of section 411(a)(9)), and no payment for the purchase of an irrevocable commitment from an insurer to pay benefits, may be made except as provided in section 432(f)(2). A plan amendment that provides for these restrictions does not violate section 411(d)(6).

(B) *Exceptions*. Pursuant to section 432(f)(2)(B), the restrictions under this paragraph (a)(3)(iii) do not apply to a benefit which under section 411(a)(11) may be immediately distributed without the consent of the participant or to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

(C) [Reserved.]

(D) *Correction of erroneous restrictions*. If the notice described in §1.432(b)–1(e) has been sent and the restrictions provided under this paragraph (a)(3)(iii) have been applied, and it is later determined that the restrictions should not have been applied, then the plan must correct any benefit payments that were restricted in error. Thus, for example, if pursuant to section 212(e)(2) of the Pension Protection Act of 2006, Public Law 109–280, 120 Stat. 780 the enrolled actuary for the plan certified that it was reasonably expected that the plan would be in critical status with respect to the first plan year beginning after 2007, and the notice described in §1.432(b)–1(e)(3)(i) was sent, but the plan is not later certified to be in critical status for that plan year, then the plan must correct any benefit payments that were restricted after the notice

was sent. Similarly, if the enrolled actuary for the plan certified that it was reasonably expected that the plan would be in critical status with respect to the first plan year beginning after 2007, and the notice described in §1.432(b)–1(e)(3)(i) was sent before the first day of that plan year, the restriction on benefits under section 432(f)(2) first applies beginning on the first day of the first plan year beginning after 2007. If the plan restricts benefits before that date, then the plan must correct any improperly restricted benefits.

(iv) *Restrictions applicable after the adoption of rehabilitation plan.* In the case of a plan that is in critical status after the adoption of the rehabilitation plan, the plan and the plan sponsor must satisfy the requirements of section 432(f)(1) until the end of the rehabilitation period.

(b) *Definitions.* The following definitions apply for purposes of section 432 and the regulations:

(1) *Accumulated funding deficiency.* The term accumulated funding deficiency has the same meaning as the term accumulated funding deficiency under section 431(a).

(2) *Active participant.* The term active participant means a participant who is in covered service under the plan.

(3) *Bargaining party.* Except as provided in paragraph (c)(1) of this section, the term bargaining party means an employer who has an obligation to contribute under the plan and an employee organization which, for purposes of collective bargaining, represents plan participants employed by an employer which has an obligation to contribute under the plan.

(4) *Benefit commencement date.* The term benefit commencement date means the annuity starting date (or in the case of a retroactive annuity starting date, the date on which benefit payments begin).

(5) *Critical status.* A multiemployer plan is in critical status if the plan meets one of the tests set forth in §1.432(b)–1(c).

(6) *Endangered status.* A plan is in endangered status if the plan meets one of the tests set forth in §1.432(b)–1(b).

(7) *Funded percentage.* The term funded percentage means a fraction (expressed as a percentage) the numerator of which is the actuarial value of the plan's assets as determined under section 431(c)(2) and the denominator of which is the accrued liability of the plan, de-

termined using the actuarial assumptions described in section 431(c)(3) and the unit credit funding method.

(8) *Funding improvement period for endangered or seriously endangered plans.* The term funding improvement period means the period that begins on the first day of the first plan year beginning after the earlier of the second anniversary of the date of the adoption of the funding improvement plan, or the expiration of the collective bargaining agreements that are in effect on the due date for the actuarial certification of endangered status for the initial endangered year and which cover, as of such due date, at least 75 percent of the active participants in the plan. The funding improvement period ends on the last day of the 10<sup>th</sup> year (15 years for seriously endangered plans, except as provided in section 432(c)(5)) after it begins or, if earlier, the date of the change in status described in section 432(c)(4)(C).

(9) *Funding plan adoption period.* The term funding plan adoption period means the period that begins on the date of the actuarial certification for the initial endangered year and ends on the day before the first day of the funding improvement period.

(10) *Inactive participant.* The term inactive participant means —

(i) A participant who is not an active participant,

(ii) A beneficiary under the plan, or

(iii) An alternate payee under the plan.

(11) *Initial critical year.* The term initial critical year means the first year for which the enrolled actuary for the plan has certified that the plan is or will be in critical status. If a plan is in critical status in one year, emerges from critical status in a subsequent year and then returns to critical status, the year of reentry into critical status is treated as the initial critical year with respect to subsequent years.

(12) *Initial endangered year.* The term initial endangered year means the first year for which the enrolled actuary for the plan has certified that the plan is in endangered status. If a plan is in endangered status in one year, changes from endangered status in a subsequent year and then returns to endangered status, the year of reentry into endangered status is treated as the initial endangered year with respect to subsequent years.

(13) *Nonbargained participant.* The term nonbargained participant means a participant in the plan whose participation is other than pursuant to a collective bargaining agreement within the meaning of section 7701(a)(46). A participant will not be treated as a nonbargained participant merely because the participant is no longer covered by the collective bargaining agreement solely as a result of retirement or severance from employment.

(14) *Obligation to contribute.* The term obligation to contribute means an obligation to contribute arising under one or more collective bargaining (or related) agreements or as a result of a duty under applicable labor-management relations law.

(15) *Plan sponsor.* Except as provided in paragraph (c)(1) of this section, the term plan sponsor means the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan.

(16) *Rehabilitation period.* The term rehabilitation period means the period that begins on the first day of the first plan year beginning after the earlier of the second anniversary of the date of the adoption of the collective bargaining agreements that are in effect on the due date for the actuarial certification of critical status for the initial critical year and which cover, as of such due date, at least 75 percent of the active participants in the plan. The rehabilitation period ends on the last day of the 10<sup>th</sup> year after it begins or, if earlier, the plan year preceding the plan year in which the plan has emerged from critical status as described in section 432(e)(4)(B).

(17) *Rehabilitation plan adoption period.* The term rehabilitation plan adoption period means the period that begins on the date of the actuarial certification for the initial critical year and ends on the day before the first day of the rehabilitation period.

(18) *Seriously endangered status.* A plan is in seriously endangered status if the plan is in endangered status and is described in both §1.432(b)–1(b)(2) and (3).

(c) *Special rules*—(1) *Plan described in section 404(c).* In the case of a plan described in section 404(c), or a continuation of such a plan, the association of employers that is the employer settlor of the plan is treated as a bargaining party and is treated

as the plan sponsor for purposes of section 432.

(2) *Plans covering both bargained and nonbargained participants.* In the case of an employer that contributes to a plan with respect to both employees who are covered by one or more collective bargaining agreements and employees who are nonbargained participants, if the plan is in endangered status or critical status, benefits of and contributions for the nonbargained participants (including surcharges on those contributions) are determined as if those nonbargained participants were covered under the employer's collective bargaining agreement in effect when the plan entered endangered or critical status that is the first to expire.

(3) *Plans covering nonbargained participants only.* In the case of an employer that contributes to a multiemployer plan only with respect to employees who are not covered by a collective bargaining agreement, section 432 and the regulations thereunder are applied as if the employer were the bargaining party, and its participation agreement with the plan were a collective bargaining agreement with a term ending on the first day of the plan year beginning after the employer is provided the schedules described in sections 432(c) and (e).

(d) *Effective/applicability date.* These regulations apply to plan years ending after March 18, 2008, but only with respect to plan years that begin on or after January 1, 2008.

Par. 3. Section 1.432(b)-1 is added to read as follows:

*§1.432(b)-1 Determination of status and adoption of a plan.*

(a) *In general.* This section provides rules relating to multiemployer plans (within the meaning of section 414(f)) that are in endangered status or critical status under section 432. Section 432 and this section only apply to multiemployer plans that are in effect on July 16, 2006. Paragraph (b) of this section sets forth the factors for determining whether a plan is in endangered status. Paragraph (c) of this section sets forth the factors for determining whether a plan is in critical status. Paragraph (d) sets forth the requirements for the annual certification by the plan's enrolled actuary. Paragraph (e) of this sec-

tion describes the notice to employees that is required for plans that are in endangered or critical status.

(b) *Determination of endangered status—(1) In general.* A plan is in endangered status for a plan year if, as determined by the enrolled actuary for the plan, the plan is not in critical status for the plan year and if, as of the beginning of the plan year, the plan is described either in paragraph (b)(2) of this section or paragraph (b)(3) of this section. The enrolled actuary's determination of whether a plan is in endangered status is made under the rules of paragraph (d)(5) of this section.

(2) *Endangered status based on funding percentage.* A plan is described in this paragraph (b)(2) for a plan year if the plan's funded percentage for such plan year is less than 80 percent.

(3) *Endangered status based on projection of funding deficiency.* A plan is described in this paragraph (b)(3) for a plan year if the plan has an accumulated funding deficiency for such plan year (or is projected to have such an accumulated funding deficiency for any of the 6 succeeding plan years), taking into account any extension of amortization periods under section 431(d).

(c) *Critical Status—(1) In general.* A multiemployer plan is in critical status for a plan year if, as determined by the enrolled actuary for the plan, the plan is described in one or more of paragraphs (c)(2) through (c)(6) of this section as of the beginning of the plan year. The enrolled actuary's determination of critical status must be made in accordance with the rules of paragraph (d)(5) of this section. Notwithstanding paragraph (d)(5)(iii) of this section, for purposes of applying the critical status tests described in paragraphs (c)(2) and (c)(5) of this section, the actuary must assume that the terms of all collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years.

(2) *Critical status based on 6-year projection of benefit payments.* A plan is described in this paragraph (c)(2) if the funded percentage of the plan is less than 65 percent, and the present value of all nonforfeitable benefits projected to be payable under the plan during the current plan year and each of the 6 succeeding plan years (plus administrative expenses

for such plan years) is greater than the sum of—

(i) The fair market value of plan assets, plus

(ii) The present value of the reasonably anticipated employer contributions for the current plan year and the 6 succeeding plan years.

(3) *Critical status based on short term funding deficiency.* A plan is described in this paragraph (c)(3) if—

(i) The plan has an accumulated funding deficiency for the current plan year, not taking into account any extension of amortization periods under section 431(d), or

(ii) The plan is projected to have an accumulated funding deficiency for any of the 3 succeeding plan years (4 succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any extension of amortization periods under section 431(d).

(4) *Critical status based on contributions less than normal cost plus interest.* A plan is described in this paragraph (c)(4) if—

(i) The present value of the reasonably anticipated employer and employee contributions for the current plan year is less than the sum of—

(A) The plan's normal cost (determined under the unit credit funding method), and

(B) Interest (determined at the rate used for determining costs under the plan) on the excess if any of—

(I) The accrued liability of the plan (determined using the actuarial assumptions described in section 431(c)(3) and the unit credit funding method) over

(2) The actuarial value of assets determined under section 431(c)(2),

(ii) The present value, as of the beginning of the current plan year, of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and

(iii) The plan has an accumulated funding deficiency for the current plan year (or is projected to have such a deficiency for any of the 4 succeeding plan years), not taking into account any extension of amortization periods under section 431(d).

(5) *Critical status based on 4-year projection of benefit payments.* A plan is described in this paragraph (c)(5) if the present value of all benefits projected to be payable under the plan during the current plan year or any of the 4 succeeding



plan years (plus administrative expenses for such plan years) is greater than the sum of—

(i) The fair market value of plan assets, plus

(ii) The present value of the reasonably anticipated employer contributions for the current plan year and each of the 4 succeeding plan years.

(6) *Critical status based on failure to meet emergence criteria.* A plan is described in this paragraph (c)(6) if—

(i) The plan was in critical status for the immediately preceding plan year, and

(ii) The enrolled actuary for the plan has certified that the plan is projected to have an accumulated funding deficiency for the plan year or any of the 9 succeeding plan years, without regard to the use of the shortfall funding method but taking into account any extensions of the amortization periods under section 431(d).

(d) *Annual certification by the plan's enrolled actuary—(1) In general.* Not later than the 90th day of each plan year of a multiemployer plan, the enrolled actuary for the plan must certify to the Secretary of the Treasury and to the plan sponsor—

(i) Whether or not the plan is in endangered status for such plan year;

(ii) Whether or not the plan is or will be in critical status for such plan year, and

(iii) In the case of a plan which is in a funding improvement or rehabilitation period, whether or not the plan is making the scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan.

(2) *Transmittal of certification—(i) Transmittal to the plan sponsor.* The certification of plan status described in paragraph (d)(1) must be submitted to the plan sponsor at the address stated by the plan sponsor on their Annual Report (Form 5500) or such other address as the plan sponsor may designate in writing for receipt of this certification.

(ii) *Transmittal to the Secretary of the Treasury.* Except as provided in guidance of general applicability to be published in the Internal Revenue Bulletin, the annual certification of plan status described in paragraph (d)(1) must be transmitted to the Secretary of the Treasury by mailing the certification to:

Internal Revenue Service  
Employee Plans Compliance Unit  
Group 7602 (SE:TEGE:EP)  
Room 1700 — 17th Floor  
230 S. Dearborn Street  
Chicago, IL 60604

(3) *Content of annual certification—(i) In general.* The annual certification must contain the information described in this paragraph (d)(3). The Secretary may add to or otherwise modify the requirements in this paragraph (d)(3) in guidance of general applicability to be published in the Internal Revenue Bulletin.

(ii) *Plan identification.* The annual certification must include the name of the plan; the plan number; the name, address, and telephone number of the plan sponsor; and the plan year for which the certification is being made.

(iii) *Enrolled actuary identification.* The annual certification must include the name, address and telephone number of the enrolled actuary signing the certification; the actuary's enrollment identification number; the actuary's signature, and the date of the signature.

(iv) *Information on plan status.* The annual certification must state whether the plan is in endangered status (which includes seriously endangered status); critical status, or neither endangered nor critical status.

(v) *Information on scheduled progress.* If the annual certification is made with respect to a plan year that is within the plan's funding improvement period or rehabilitation period arising from a prior certification of endangered or critical status, the actuary must also certify whether or not the plan is making scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan.

(4) *Penalty for failure to secure timely actuarial certification.* A failure of a plan's actuary to certify the plan's status under this paragraph (d) by the date specified in paragraph (d)(1) of this section is treated as a failure or refusal by the plan administrator to file the annual report required to be filed with the Secretary of Labor under section 101(b)(4) of the Employee Retirement Income Security Act of 1974.

(5) *Actuarial projections of assets and liabilities—(i) In general.* In making the determinations and projections under sec-

tion 432(b) and this section, the enrolled actuary for the plan must make projections required for the current and succeeding plan years of the current value of the assets of the plan and the present value of all liabilities to participants and beneficiaries under the plan for the current plan year as of the beginning of such year. These projections must be based on reasonable actuarial estimates, assumptions, and methods in accordance with section 431(c)(3) and that offer the actuary's best estimate of anticipated experience under the plan. Notwithstanding the previous sentence, the actuary is permitted to rely on the plan sponsor's projection of activity in the industry provided under paragraph (d)(5)(iii) of this section. The projected present value of liabilities as of the beginning of such year must be determined based on the most recent information reported on the most recent of either—

(A) The actuarial statement required under section 103(d) of the Employee Retirement Income Security Act of 1974 that has been filed with respect to the most recent year, or

(B) The actuarial valuation for the preceding plan year.

(ii) *Determinations of future contributions.* Any actuarial projection of plan assets shall assume either—

(A) Reasonably anticipated employer contributions for the current and succeeding plan years, assuming that the terms of the one or more collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years, or

(B) That employer contributions for the most recent plan year will continue indefinitely, but only if the enrolled actuary for the plan determines there have been no significant demographic changes that would make such assumption unreasonable.

(iii) *Projected industry activity.* The plan sponsor shall provide any necessary projection of activity in the industry, including future covered employment, to the plan actuary. For this purpose, the plan sponsor must act reasonably and in good faith.

(6) *Treatment of amortization extensions under section 412(e).* For purposes of section 432, if the plan received an extension of any amortization period under section 412(e), the extension is treated the

same as an extension under section 431(d). Thus, such an extension is not taken into account in determining whether a plan has or will have an accumulated funding deficiency under paragraph (c)(3) and (c)(4) of this section, but it is taken into account in determining whether a plan has or will have an accumulated funding deficiency under paragraph (b)(3) of this section.

(e) *Notice of endangered or critical status*—(1) *In general.* In any case in which the enrolled actuary for the plan certifies that a multiemployer plan is or will be in endangered or critical status for a plan year, the plan sponsor must, not later than 30 days after the date of the certification, provide notification of the endangered or critical status to the participants and beneficiaries, the bargaining parties, the Pension Benefit Guaranty Corporation, and the Secretary of Labor.

(2) *Plans in critical status.* If it is certified that a multiemployer plan is or will be in critical status for a plan year, the plan sponsor must include in the notice an explanation of the possibility that adjustable benefits (as defined in section 432(e)(8)) may be reduced, and such reductions may apply to participants and beneficiaries whose benefit commencement date is on or after the date such notice is provided for the first plan year in which the plan is in critical status. If the plan provides benefits that are restricted under section 432(f)(2), the notice must also include an explanation that the plan cannot pay single sums and similar benefits described in section 432(f)(2) that are greater than the monthly amount due under a single life annuity. A plan sponsor that sends the model notice issued by the Secretary of Labor pursuant to section 432(b)(3)(D)(iii) satisfies this requirement.

(3) *Transition rules*—(i) *Early notice permitted.* If, after August 17, 2006, the enrolled actuary for the plan certifies that a plan is reasonably expected to be in critical status with respect to the first plan year beginning after 2007, then the notice described in this paragraph (e) may be provided before the date the actuary certifies the plan is in critical status for that plan year. The ability to provide early notice does not extend the otherwise applicable deadline for providing the notice under paragraph (e)(1) of this section.

(ii) *Reformation of prior notice.* If notice has been provided prior to the date re-

quired under paragraph (e)(1) of this section, but the notice did not include all of the information described in paragraph (e)(2) of this section, then that notice will not satisfy the requirements for notice under section 432(b)(3)(D). Accordingly, the restrictions under section 432(f)(2) will not apply as a result of the issuance of such a notice. However, if prior to the date notice is required to be provided under paragraph (e)(1) of this section additional notice is provided that includes all of the information required under paragraph (e)(2) of this section, then the notice requirements of section 432(b)(3)(D) are satisfied as of the date of that additional notice and the restrictions of section 432(f)(2) will apply beginning on that date. In such a case, the date of the earlier notice will still apply for purposes of section 432(e)(8)(A)(ii) provided that the earlier notice included all of the information required under section 432(b)(3)(D)(ii).

(f) *Effective/applicability date.* These regulations apply to plan years ending after March 18, 2008, but only with respect to plan years that begin on or after January 1, 2008.

Linda E. Stiff,  
*Deputy Commissioner for  
Services and Enforcement.*

(Filed by the Office of the Federal Register on March 14, 2008, 9:03 a.m., and published in the issue of the Federal Register for March 18, 2008, 73 FR. 14417)

## **Reduction of Foreign Tax Credit Limitation Categories Under Section 904(d); Correction**

### **Announcement 2008–30**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations; Correction

SUMMARY: This document contains corrections to final and temporary regulations (T.D. 9368, 2008–6 I.R.B. 382) that were published in the **Federal Register** on Friday, December 21, 2007 (72 FR 72582) regarding the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Internal

Revenue Code. These regulations affect taxpayers claiming foreign tax credits and provide guidance needed to comply with the statutory changes made by the American Jobs Creation Act of 2004 (AJCA).

DATES: The correction is effective March 21, 2008.

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry, (202) 622–3850 (not a toll-free number).

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

The final and temporary regulations (T.D. 9368) that are the subject of the correction are under section 904 of the Internal Revenue Code.

##### **Need for Correction**

As published, final and temporary regulations (T.D. 9368) 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. 9368), which were the subject of FR Doc. E7–24782, is corrected as follows:

1. On page 72585, column 1, in the preamble, under the paragraph heading “V. Post-1986 Undistributed Earnings and Post-1986 Foreign Income Taxes of a Foreign Corporation as of the End of the Corporation’s Last Pre-2007 Taxable Year”, second line of the first paragraph of the column, the language “described in section 959(c)(1)(A),” is corrected to read “described in section 959(c)(1) and (2),”.

2. On page 72586, column 3, in the preamble, under the paragraph heading “VI. Separate Limitation Losses and Overall Foreign Losses”, first line of the second paragraph of the column, the language “Section 1.904–12T(h)(4) provides that” is corrected to read “Section 1.904(f)–12T(h)(4) provides that”.

3. On page 72586, column 3, in the preamble, under the paragraph heading “VI. Separate Limitation Losses and Overall Foreign Losses”, first line of the third paragraph of the column, the

language “Section 1.904–12T(h)(5) provides that” is corrected to read “Section 1.904(f)–12T(h)(5) provides that”.

4. On page 72586, column 3, in the preamble, under the paragraph heading “VI. Separate Limitation Losses and Overall Foreign Losses”, sixth line of the third paragraph of the column, the language “rules of § 1.904–12T(g)(1) and (2)” is corrected to read “rules of § 1.904(f)–12T(g)(1) and (2)”.

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 March 20, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 21, 2008, 73 F.R. 15063)

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

### Announcement 2008–32

The Internal Revenue Service has revoked its determination that the organizations listed below qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Internal Revenue Code of 1986.

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 organiza-

tions described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on April 21, 2008, 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.

Educate the Children Foundation  
Long Beach, CA  
CFIDS Walk-A-Thon Committee  
Hicksville, NY  
Open Doors, Inc.  
Duluth, GA  
Amalgamated Credit Counselors  
Lauderhill, FL  
Carter Lake Charitable  
Urbandale, IA  
Christian Credit Counselors, Inc.  
Las Vegas, NV  
In Time Youth Group  
Ontario, OR  
Young Lions Foundation  
Sausalito, CA  
Charity Connections, Ltd.  
Pittsford, NY  
North-Tartan Area Girls Basketball  
Booster Club  
Oakdale, MN

## Stock Transfer Rules: Carryover of Earnings and Taxes

### Announcement 2008–33

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains a correction to final regulations (T.D. 9273, 2006–2 C.B. 394) that were published in the **Federal Register** on Tuesday, August 8, 2006 (71 FR 44887) addressing the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations

combine in a corporate reorganization or liquidation that is described in both sections 367(b) and 381 of the Internal Revenue Code.

DATES: This correction is effective March 18, 2008.

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry at (202) 622–3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Background

The final regulations (T.D. 9273) that are the subject of this correction are under section 367(b) of the Internal Revenue Code.

#### Need for Correction

As published, final regulations (T.D. 9273) contain errors that may prove to be misleading and are in need of clarification.

\* \* \* \* \*

#### Correction of Publication

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

#### PART 1—INCOME TAXES

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

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

Par. 2. Section 1.367(b)–6 is amended by revising paragraph (a)(1) to read as follows:

§ 1.367(b)–6 *Effective dates and coordination rules.*

(a) *Effective date.* (1) *In general.* Except as otherwise provided in this paragraph (a)(1), §§ 1.367(b)–1 through 1.367(b)–5, and this section, apply to section 367(b) exchanges that occur on or after February 23, 2000. The rules of §§ 1.367(b)–3 and 1.367(b)–4, as they apply to reorganizations described in section 368(a)(1)(A) (including reorganizations described in section 368(a)(2)(D) or (E)) involving a foreign acquiring or foreign acquired corporation, apply only to transfers occurring on or after January 23, 2006. Section 1.367(b)–4(b)(1)(ii) applies to all

triangular reorganizations and reorganizations described in section 368(a)(1)(G) and (a)(2)(D) occurring on or after January 23, 2006, although taxpayers may apply § 1.367(b)-4(b)(1)(ii) to triangular B reorganizations occurring on or after February 23, 2000, in a taxable year that is not closed by the period of limitations if done consistently with respect to all such triangular B reorganizations. The second sentence of paragraph (a) in § 1.367(b)-4 shall apply to section 304(a)(1) transactions occurring on or after February 23, 2006; however, taxpayers may rely on this sentence for all section 304(a)(1) transactions occurring in open taxable years. Section 1.367(b)-1(c)(2)(v), (c)(3)(ii)(A), (c)(4)(iv), (c)(4)(v), 1.367(b)-2(j)(1)(i), (I), and 1.367(b)-3(e) and (f), apply to section 367(b) exchanges that occur on or after November 6, 2006. For guidance with respect to § 1.367(b)-1(c)(3)(ii)(A) and (c)(4)(iv) and (v) and § 1.367(b)-2(j)(1)(i) for exchanges that occur before November 6, 2006, see 26 CFR part 1 revised as of April 1, 2006.

\* \* \* \* \*

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

(Filed by the Office of the Federal Register on March 17, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 18, 2008, 73 F.R. 14386)

## Reduction of Foreign Tax Credit Limitation Categories Under Section 904(d); Hearing Cancellation

### Announcement 2008-36

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Cancellation of notice of public hearing on proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: This document cancels a public hearing on proposed regulations (REG-114126-07, 2008-6 I.R.B. 410) that provide guidance relating to the reduction of the number of separate foreign tax credit limitation categories under section 904(d) of the Internal Revenue Code. Changes to the applicable law were made by the American Jobs Creation Act of 2004 reducing the number of section 904(d) separate categories from eight to two, effective for taxable years beginning after December 31, 2006.

DATES: The public hearing, originally scheduled for April 22, 2008 at 10 a.m. is cancelled.

FOR FURTHER INFORMATION CONTACT: Funmi Taylor of the Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration) at (202) 622-3628 (not a toll-free number).

SUPPLEMENTARY INFORMATION: A notice of proposed rulemaking by cross-reference to temporary regulations and a notice of public hearing that appeared in the **Federal Register** on Friday, December 21, 2007 (72 FR 72645) announced that a public hearing was scheduled for April 22, 2008, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. The subject of the public hearing is under the section 904 of the Internal Revenue Code.

The public comment period for these regulations expired on March 20, 2008. The notice of proposed rulemaking by cross reference to temporary regulations and notice of public hearing instructed those interested in testifying at the public hearing to submit a request to speak and an outline of the topics to be addressed. As of Tuesday, March 25, 2008, no one has requested to speak. Therefore, the public hearing scheduled for April 22, 2008, is cancelled.

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 March 27, 2008, 8:45 a.m., and published in the issue of the Federal Register for March 28, 2008, 73 F.R. 16610)

# 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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Notice 2008-39, 2008-13 I.R.B. 684

#### 2003-51

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Rev. Proc. 2008-24, 2008-13 I.R.B. 684

#### 2006-27

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Notice 2008-35, 2008-12 I.R.B. 647

#### 2006-28

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Notice 2008-36, 2008-12 I.R.B. 650

#### 2006-52

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Notice 2008-40, 2008-14 I.R.B. 725

#### 2006-77

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<sup>1</sup> A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2007–27 through 2007–52 is in Internal Revenue Bulletin 2007–52, dated December 26, 2007.



**Treasury Decisions:**

**9273**

Corrected by

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**9362**

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Ann. 2008-9, 2008-7 I.R.B. 444

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**9368**

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Ann. 2008-30, 2008-16 I.R.B. 825

**9375**

Corrected by

Ann. 2008-16, 2008-9 I.R.B. 511





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