Internal Revenue bulletin

Bulletin No. 2005-24
June 13, 2005

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2005–35, page 1214.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning July 1, 2005, will be 6 percent for overpayments (5 percent in the case of a corporation), 6 percent for underpayments, and 8 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 will be 3.5 percent.

T.D. 9202, page 1213.

Final regulations under section 1031 of the Code replace the Standard Industrial Classification (SIC) system of codes with the North American Industry Classification System (NAICS) for purposes of determining what depreciable tangible personal property is like-kind to other property.

REG–100420–03, page 1236.

Proposed regulations under section 475 of the Code set forth an elective safe harbor for dealers in securities and/or commodities and traders in securities and commodities that permits these taxpayers to make an election pursuant to which the values of the positions reported on certain financial statements are the fair market values of those positions. The safe harbor is based upon the principle that if the mark-to-market method used for financial reporting is sufficiently consistent with the mark-to-market method required by section 475, then the values used for financial reporting should be acceptable values for purposes of section 475, even if those values are not fair market values under general tax principles. To ensure minimal divergence from fair market values under tax principles, the regulations impose certain restrictions on the financial accounting methods and statements that are eligible for the safe harbor and may require certain adjustments to values used in the safe harbor. This safe harbor attempts to reduce the compliance burden upon taxpayers and to improve the administrability of valuations for the IRS. A public hearing is scheduled for September 15, 2005.

REG–105346–03, page 1244.

Proposed regulations under section 83 of the Code withdraw the remaining portion of the notice of proposed rulemaking published in the Federal Register on June 3, 1971 (36 FR 10787) and contain proposed regulations relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services. The regulations provide that the transfer of a partnership interest in connection with the performance of services is subject to section 83 and provide rules for coordinating section 83 with partnership taxation principles. The regulations also provide that no gain or loss is recognized by a partnership on the transfer or vesting of an interest in the transferring partnership in connection with the performance of services for the transferring partnership. A public hearing is scheduled for October 5, 2005.

REG–127740–04, page 1254.

Proposed regulations under sections 367(a) and (b) of the Code relate to certain transfers of stock involving foreign corporations pursuant to section 304(a)(1).

Notice 2005–43, page 1221.

This notice includes a proposed revenue procedure providing additional rules for the elective safe harbor under the proposed regulations under section 83 of the Code governing the application of section 83 to the transfer of a partnership interest in connection with the performance of services.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Notice 2005–45, page 1228.
Deductions for entertainment use of aircraft. This notice provides interim guidance to taxpayers on the limitation under section 274(e) of the Code on the deductible amount of trade or business expenses incurred after October 22, 2004, for use of a business aircraft for entertainment.

ESTATE TAX

Rev. Proc. 2005–33, page 1231.
This procedure provides guidance on exhausting administrative remedies prior to seeking a declaratory judgment pursuant to section 7479 of the Code.

EMPLOYMENT TAX

Rev. Proc. 2005–34, page 1233.
This procedure sets forth updated procedures for appeals of proposed trust fund recovery penalty assessments arising under section 6672 of the Code. The procedures apply to trust fund recovery penalty cases relating to employment and excise taxes imposed under the Code, except when collection is in jeopardy. Rev. Proc. 84–78 superseded.

EXCISE TAX

Rev. Proc. 2005–34, page 1233.
This procedure sets forth updated procedures for appeals of proposed trust fund recovery penalty assessments arising under section 6672 of the Code. The procedures apply to trust fund recovery penalty cases relating to employment and excise taxes imposed under the Code, except when collection is in jeopardy. Rev. Proc. 84–78 superseded.

ADMINISTRATIVE

REG–100420–03, page 1236.
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Announcement 2005–42, page 1257.
This announcement contains the annual report concerning the Pre-Filing Agreement program of the Large and Mid-Size Business Division of the Service for Calendar Year 2004.

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 1031.—Exchange of Property Held for Productive Use or Investment

26 CFR 1.1031(a)–2: Additional rules for exchanges of personal property.

T.D. 9202

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Additional Rules for Exchanges of Personal Property under Section 1031(a)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that replace the use of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) for determining what properties are of a like class for purposes of section 1031 of the Internal Revenue Code (Code). The regulations affect taxpayers that engage in like-kind exchanges of depreciable tangible personal property.

DATES: *Effective Date:* These regulations are effective May 19, 2005.

Applicability Dates: For dates of applicability, see §1.1031(a)–2(d).

FOR FURTHER INFORMATION CONTACT: J. Peter Baumgarten, (202) 622–4920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR Part 1. On August 13, 2004, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG–116265–04, 2004–38 I.R.B. 501 [69 FR 50108]) by cross reference to temporary regulations (T.D. 9151, 2004–38 I.R.B. 489 [69 FR 50067]) under section 1031(a). These amendments relate to the transition from the use of the four-digit codes under the SIC system to the six-digit NAICS for determining product classes of depreciable tangible personal property exchanged under section 1031. No written or electronic comments in response to the proposed regulations or requests to speak at a public hearing were received, and no hearing was held. The proposed regulations under section 1031 are adopted by this Treasury decision, and the temporary regulations are removed.

Effective Date

These final regulations apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply the regulations to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired. Additionally, taxpayers may treat properties within the same product classes under a 4-digit SIC code as properties of like class for transfers of property made by taxpayers on or before May 19, 2005.

Special Analysis

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

Drafting Information

The principal author of these final regulations is J. Peter Baumgarten of the Office of the Associate Chief Counsel (Income Tax and Accounting). 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 1.1031(a)–2 is amended by:

1. Revising paragraphs (b)(3) through (b)(6), *Example 3* and *Example 4* of paragraph (b)(7), and paragraph (d).

2. Adding paragraph (b)(8).

The revisions and addition read as follows.

§1.1031(a)–2 Additional rules for exchanges of personal property.

* * * * *

(b)* * *

(3) *Product classes*. Except as provided in paragraphs (b)(4) and (5) of this section, or as provided by the Commissioner in published guidance of general applicability, property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, *North American Industry Classification System*, United States, 2002 (NAICS Manual), as periodically updated. Copies of the NAICS Manual may be obtained from the National

Technical Information Service, an agency of the U.S. Department of Commerce, and may be accessed on the internet. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of described products and equipment. For this purpose, any 6-digit NAICS product class with a last digit of 9 (a miscellaneous category) is not a product class for purposes of this section. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 6-digit product class is referred to as the property's NAICS code.

(4) *Modifications of NAICS product classes*. The product classes of the NAICS Manual may be updated or otherwise modified from time to time as the manual is updated, effective on or after the date of the modification. The NAICS Manual generally is modified every five years, in years ending in a 2 or 7 (such as 2002, 2007, and 2012). The applicability date of the modified NAICS Manual is announced in the **Federal Register** and generally is January 1 of the year the NAICS Manual is modified. Taxpayers may rely on these modifications as they become effective in structuring exchanges under this section. Taxpayers may rely on the previous NAICS Manual for transfers of property made by a taxpayer during the one-year period following the effective date of the modification. For transfers of property made by a taxpayer on or after January 1, 1997, and on or before January 1, 2003, the NAICS Manual of 1997 may be used for determining product classes of the exchanged property.

(5) *Administrative procedures for revising general asset classes and product classes*. The Commissioner may, through published guidance of general applicability, supplement, modify, clarify, or update the guidance relating to the classification of properties provided in this paragraph (b). (See §601.601(d)(2) of this chapter.) For example, the Commissioner may determine not to follow (in whole or in part) a general asset class for purposes of identifying property of like class, may determine not to follow (in whole or in part) any modification of product classes published in the NAICS Manual, or may determine that other properties not listed within the same or in any product class or general asset class nevertheless are of a like class. The Commissioner also may determine that two items of property that are listed in separate product classes or in product classes with a last digit of 9 are of a like class, or that an item of property that has a NAICS code is of a like class to an item of property that does not have a NAICS code.

(6) *No inference outside of section 1031*. The rules provided in this section concerning the use of general asset classes or product classes are limited to exchanges under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

(7) *Examples*. * * *

* * * * *

Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of section 1031.

Example 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (NAICS code 333210), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class 00.242) and a lathe (NAICS code 333210). The personal computer and the printer are of a like class because they are within the same general asset class. The sanding machine and the lathe are of a like class because they are within the same product class (although neither property is within any of the general asset classes). The airplane and the heavy general purpose truck are neither within the same general asset class nor within the same product class, and are not of a like kind.

(8) *Transition rule*. Properties within the same product classes based on the 4-digit codes contained in Division D of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987), will be treated as property of a like class for transfers of property made by taxpayers on or before May 19, 2005.

* * * * *

(d) *Effective date*. Except as otherwise provided in this paragraph (d), this section applies to exchanges occurring on or after April 11, 1991. Paragraphs (b)(3) through (b)(6), *Example 3* and *Example 4* of paragraph (b)(7), and paragraph (b)(8) of this section apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply paragraphs (b)(3) through (b)(6), and *Example 3* and *Example 4* of paragraph (b)(7) of this section to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired.

§1.1031(a)–2T [Removed]

Par. 3. Section 1.1031(a)–2T is removed.

§1.1031(j)–1 [Amended]

Par. 4. Section 1.1031(j)–1(d) is amended by removing the language "(SIC Code 3531)" in *Example 3*(ii)(C) and *Example 5*(i) and adding "(NAICS code 333120)" in its place.

Cono R. Namorato,
Acting Deputy Commissioner for Services and Enforcement.

Approved May 12, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 18, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 19, 2005, 70 F.R. 28818)

Section 6621.—Determination of Rate of Interest

26 CFR 301.6621–1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning July 1, 2005, will be 6 percent for overpayments (5 percent in the case of a corporation), 6 percent for underpayments, and 8 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 will be 3.5 percent.

Rev. Rul. 2005–35

Section 6621 of the Internal Revenue Code establishes the rates for interest on tax overpayments and tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 3 percentage points (2 percentage points in the case of a corporation), except the rate for the portion of a corporate overpayment of tax exceeding

$10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under section 6601 on any large corporate underpayment, the underpayment rate under section 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See section 6621(c) and section 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and section 301.6621–3 are generally effective for periods after December 31, 1990.

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

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

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

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

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of April 2005 is 3 percent. Accordingly, an overpayment rate of 6 percent (5 percent in the case of a corporation) and an underpayment rate of 6 percent are established for the calendar quarter beginning July 1, 2005. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 for the calendar quarter beginning July 1, 2005, is 3.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning July 1, 2005, is 8 percent. These rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 3.5 percent, 5 percent, 6 percent, and 8 percent are published in Tables 12, 15, 17, and 21 of Rev. Proc. 95–17, 1995–1 C.B. 556, 566, 569, 571, and 575.

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

DRAFTING INFORMATION

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

TABLE OF INTEREST RATES

PERIODS BEFORE JUL. 1, 1975 — PERIODS ENDING DEC. 31, 1986

OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	In 1995–1 C.B. DAILY RATE TABLE
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25, pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES

FROM JAN. 1, 1987 — Dec. 31, 1998

	OVERPAYMENTS			UNDERPAYMENTS		
		1995–1 C.B.			1995–1 C.B.	
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577
Apr. 1, 1997—Jun. 30, 1997	8%	21	575	9%	23	577
Jul. 1, 1997—Sep. 30, 1997	8%	21	575	9%	23	577
Oct. 1, 1997—Dec. 31, 1997	8%	21	575	9%	23	577
Jan. 1, 1998—Mar. 31, 1998	8%	21	575	9%	23	577
Apr. 1, 1998—Jun. 30, 1998	7%	19	573	8%	21	575
Jul. 1, 1998—Sep. 30, 1998	7%	19	573	8%	21	575
Oct. 1, 1998—Dec. 31, 1998	7%	19	573	8%	21	575

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

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

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

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE	1995–1 C.B. TABLE	PG	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 1999—Mar. 31, 1999	6%	17	571	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	7%	19	573	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	7%	19	573	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	7%	19	573	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	7%	67	621	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	8%	69	623	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	8%	69	623	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	8%	69	623	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	8%	21	575	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	7%	19	573	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	6%	17	571	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	6%	17	571	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	5%	15	569	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	5%	15	569	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	5%	15	569	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	5%	15	569	6%	17	571

TABLE OF INTEREST RATES

FROM JANUARY 1, 1999 — PRESENT – Continued

CORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE	1995–1 C.B. TABLE	PG	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 2003—Mar. 31, 2003	4%	13	567	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	4%	13	567	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	4%	13	567	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	3%	11	565	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	3%	59	613	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	4%	61	615	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	3%	59	613	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	4%	61	615	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	4%	13	567	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	5%	15	569	6%	17	571
Jul. 1, 2005—Sep. 30, 2005	5%	15	569	6%	17	571

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991 — PRESENT

	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581
Jan. 1, 1998—Mar. 31, 1998	11%	27	581
Apr. 1, 1998—Jun. 30, 1998	10%	25	579
Jul. 1, 1998—Sep. 30, 1998	10%	25	579
Oct. 1, 1998—Dec. 31, 1998	10%	25	579
Jan. 1, 1999—Mar. 31, 1999	9%	23	577
Apr. 1, 1999—Jun. 30, 1999	10%	25	579

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991 — PRESENT – Continued

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

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995 — PRESENT

	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572
Jan. 1, 1998—Mar. 31, 1998	6.5%	18	572
Apr. 1, 1998—Jun. 30, 1998	5.5%	16	570
Jul. 1, 1998—Sep. 30, 1998	5.5%	16	570
Oct. 1, 1998—Dec. 31, 1998	5.5%	16	570
Jan. 1, 1999—Mar. 31, 1999	4.5%	14	568
Apr. 1, 1999—Jun. 30, 1999	5.5%	16	570
Jul. 1, 1999—Sep. 30, 1999	5.5%	16	570
Oct. 1, 1999—Dec. 31, 1999	5.5%	16	570
Jan. 1, 2000—Mar. 31, 2000	5.5%	64	618

TABLE OF INTEREST RATES FOR CORPORATE OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995 — PRESENT – Continued

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

Part III. Administrative, Procedural, and Miscellaneous

Proposed Revenue Procedure Regarding Partnership Interests Transferred in Connection With the Performance of Services

Notice 2005–43

Purpose

This notice addresses the taxation of a transfer of a partnership interest in connection with the performance of services. In conjunction with this notice, the Treasury Department and the Internal Revenue Service are proposing regulations under § 83 of the Internal Revenue Code. The proposed regulations grant the Commissioner authority to issue guidance of general applicability related to the taxation of the transfer of a partnership interest in connection with the performance of services. This notice includes a proposed revenue procedure under that authority. The proposed revenue procedure provides additional rules for the elective safe harbor under proposed § 1.83–3(l) for a partnership's transfers of interests in the partnership in connection with the performance of services for that partnership. The safe harbor is intended to simplify the application of § 83 to partnership interests and to coordinate the provisions of § 83 with the principles of partnership taxation. Upon the finalization of the proposed revenue procedure, Rev. Proc. 93–27, 1993–2 C.B. 343, and Rev. Proc. 2001–43, 2001–2 C.B. 191, (described below) will be obsoleted. Until that occurs, taxpayers may not rely upon the safe harbor set forth in the proposed revenue procedure, but taxpayers may continue to rely upon current law, including Rev. Proc. 93–27, 1993–2 C.B. 343, and Rev. Proc. 2001–43, 2001–2 C.B. 191.

Effective Date

The Treasury Department and the Service intend for the revenue procedure proposed in this notice to be finalized and made effective in conjunction with the finalization of the related proposed regulations under § 83 and subchapter K of chapter 1 of the Internal Revenue Code (subchapter K).

Request for Comments

Comments are requested on the proposed revenue procedure in this notice. Although the Treasury Department and the Service request comments on all aspects of the proposed revenue procedure, comments are requested specifically on the following:

1. Whether additional guidance is needed to address the transfer of an interest in a partnership to a person who is not rendering services directly to such partnership (for example, an upper-tier partnership transfers an interest in a lower-tier partnership to a person for services rendered to the upper-tier partnership).

2. Whether election of the safe harbor described in proposed § 1.83–3(l) and the proposed revenue procedure should be permitted on Form 1065, *U.S. Return of Partnership Income*, and whether continued use of the safe harbor should be reported annually on Form 1065 and Schedule K–1, Partner's Share of Income, Deductions, Credits, etc.

Comments may be submitted on or before August 22, 2005 to Internal Revenue Service, PO Box 7604, Washington, DC 20044, Attn: CC:PA:LPD:PR (Notice 2005–43), Room 5203. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, NW, Washington DC 20224, Attn: CC:PA:LPD:PR (Notice 2005–43), Room 5203. Submissions may also be sent electronically via the internet to the following email address: *Notice.comments@irscounsel.treas.gov.* Include the notice number (Notice 2005–43) in the subject line.

Drafting Information

The principal authors of this notice are Stephen Tackney of the Office of Associate Chief Counsel (Tax Exempt and Government Entities); and Audrey Ellis and Demetri Yatrakis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice and the application of § 83, contact Stephen Tackney at (202) 622–6030 (not a toll-free call). For further information regarding this notice and the application of the rules contained in subchapter K, contact Audrey Ellis or Demetri Yatrakis at (202) 622–3060 (not a toll-free call).

PROPOSED REVENUE PROCEDURE

SECTION 1. PURPOSE

Proposed § 1.83–3(l) of the Income Tax Regulations allows taxpayers to elect to apply special rules (the Safe Harbor) to a partnership's transfers of interests in the partnership in connection with the performance of services for the partnership. The Treasury Department and the Internal Revenue Service intend for the Safe Harbor to simplify the application of § 83 of the Internal Revenue Code to partnership interests transferred in connection with the performance of services and to coordinate the principles of § 83 with the principles of partnership taxation. This revenue procedure sets forth additional rules for the elective safe harbor under proposed § 1.83–3(l) for a partnership's transfer of interests in the partnership in connection with the performance of services for that partnership.

SECTION 2. LAW AND DISCUSSION

Section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, is included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not

subject to a substantial risk of forfeiture, whichever is applicable.

Section 1.83–3(e) provides that, for purposes of § 83 and the regulations thereunder, the term property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. For these purposes, under proposed § 1.83–3(e) property includes a partnership interest. Generally, a mere right to allocations or distributions described in § 707(a)(2)(A) is not a partnership interest. Proposed § 1.83–3(e) also provides that, in the case of a transfer of a partnership interest in connection with the performance of services, the Commissioner may prescribe generally applicable administrative rules to address the application of § 83 to the transfer.

Section 83(b) provides that a service provider may elect to include in his or her gross income, for the taxable year in which substantially nonvested property is transferred, the excess of (1) the fair market value of the property at the time of the transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over (2) the amount (if any) paid for the property. If such an election is made, § 83(a) does not apply with respect to the transfer of the property upon vesting and, if the property is subsequently forfeited, no deduction is allowed to the service provider in respect of the forfeiture.

Section 1.83–2(b) provides that an election under § 83(b) must be filed not later than 30 days after the date the property was transferred and may be filed prior to the date of the transfer. Section 1.83–2(c) provides that the election is made by filing one copy of a written statement with the Internal Revenue Service Center with which the service provider files his or her return. In addition, one copy of such statement must be submitted with the service provider's income tax return for the taxable year in which the property was transferred.

Section 1.83–1(a) provides that, unless an election under § 83(b) is made, the transferor is regarded as the owner of substantially nonvested property transferred in connection with the performance of services until such property becomes substantially vested, and any income from such property received by the service provider (or beneficiary thereof), or the right to the use of such property by the service provider, constitutes additional compensation and is included in the gross income of the service provider for the taxable year in which the income is received or the use is made available. Under this rule, a partnership must treat as unissued any substantially nonvested partnership interest transferred in connection with the performance of services for which an election under § 83(b) has not been made. If the service provider who holds such an interest receives distributions from the partnership with respect to that interest while the interest is substantially nonvested, the distributions are treated as compensation in the capacity in which the service provider performed the services. For example, if a service provider that is not a pre-existing partner holds a substantially nonvested partnership interest that the service provider received in connection with the performance of services and the service provider did not make an election under § 83(b) with respect to that interest, then any distributions made to the service provider on account of such interest are treated as additional compensation and not partnership distributions. If, instead, the service provider who receives a substantially nonvested partnership interest in connection with the performance of services makes a valid election under § 83(b), then the service provider is treated as the owner of the property. *See* Rev. Rul. 83–22, 1983–1 C.B. 17. The service provider is treated as a partner with respect to such an interest, and the partnership must allocate partnership items to the service provider as if the partnership interest were substantially vested.

Section 1.83–3(b) provides that property is substantially nonvested for § 83 purposes when it is subject to a substantial risk of forfeiture and is nontransferable. Property is substantially vested for § 83 purposes when it is either transferable or not subject to a substantial risk of forfeiture.

Section 1.83–3(c) provides that, for § 83 purposes, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Section 1.83–3(d) provides that, for § 83 purposes, the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture.

Proposed § 1.83–3(l) provides that, subject to such additional conditions, rules, and procedures that the Commissioner may prescribe in regulations, revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin, a partnership and all of its partners may elect a safe harbor under which the fair market value of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest for transfers on or after the date final regulations are published in the Federal Register if the following conditions are satisfied: (1) the partnership must prepare a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor apply irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect and attach the document to the tax return for the partnership for the taxable year that includes the effective date of the election; (2) except as provided below, the partnership agreement must contain provisions that are legally binding on all of the partners stating that (a) the partnership is authorized and directed to elect the safe harbor, and (b) the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective; and (3) if the partnership agreement does not contain the provisions described in clause (2) of this sentence, or the provisions are not legally binding on all of the partners of

the partnership, then each partner in a partnership that transfers a partnership interest in connection with the performance of services must execute a document containing provisions that are legally binding on that partner stating that (a) the partnership is authorized and directed to elect the safe harbor, and (b) the partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. The specified effective date of the safe harbor election may not be prior to the date that the safe harbor election is executed. Proposed § 1.83–3(l) provides that the partnership must retain such records as may be necessary to indicate that an effective election has been made and remains in effect, including a copy of the partnership's election statement under this paragraph (l), and, if applicable, the original of each document submitted to the partnership by a partner under this paragraph (l). If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the election. The safe harbor election also may be terminated by the partnership preparing a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, which states that the partnership, on behalf of the partnership and each of its partners, is revoking the safe harbor election on the stated effective date, and attaching the document to the tax return for the partnership for the taxable year that includes the effective date of the revocation.

Section 83(h) provides that, in the case of a transfer of property in connection with the performance of services or a cancellation of a restriction described in § 83(d), there is allowed as a deduction under § 162, to the person for whom the services were performed (the service recipient), an amount equal to the amount included under § 83(a), (b), or (d)(2) in the gross income of the service provider. The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which such amount is included in the gross income of the service provider. Under § 1.83–6(a)(3), if property is substantially vested upon the transfer, the deduction is allowed to the service recipient in accordance with its method of accounting (in conformity with §§ 446 and 461).

Section 1.83–6(c) provides that if, under § 83(h) and § 1.83–6(a), a deduction, an increase in basis, or a reduction of gross income was allowable (disregarding the reasonableness of the amount of compensation) in respect of a transfer of property and such property is subsequently forfeited, the amount of such deduction, increase in basis, or reduction of gross income shall be includible in the gross income of the person to whom it was allowable for the taxable year of the forfeiture. The basis of such property in the hands of the person to whom it is forfeited shall include any such amount includible in the gross income of such person, as well as any amount such person pays upon forfeiture.

Section 704(b) requires that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) be determined in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances, if (1) the partnership agreement does not provide otherwise as to the partner's distributive share, or (2) the allocation to a partner under the agreement does not have substantial economic effect.

Proposed § 1.704–1(b)(2)(iv)(*b*)(*1*) provides that a partner's capital account includes the amount contributed by that partner to the partnership, and, in the case of a compensatory partnership interest that is transferred on or after the date final regulations are published in the **Federal Register**, the amount included on or after that date as the partner's compensation income under § 83(a), (b), or (d)(2). For these purposes, a compensatory partnership interest is an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership (either before or after the formation of the partnership), including an interest that is transferred on the exercise of a compensatory partnership option. A compensatory partnership option is an option to acquire an interest in the issuing partnership that is granted in connection with the performance of services for that partnership (either before or after the formation of the partnership). *See* proposed § 1.721–1(b)(4).

Proposed § 1.704–1(b)(4)(xii)(*a*) provides that if a § 83(b) election has been made with respect to a substantially nonvested interest, allocations of partnership items while the interest is substantially nonvested cannot have economic effect.

Proposed § 1.704–1(b)(4)(xii)(*b*) provides that allocations of partnership items to a holder of a substantially nonvested interest for which a § 83(b) election has been made will be deemed to be in accordance with the partners' interests in the partnership if the partnership agreement requires that: (1) in the event that the interest for which the § 83(b) election is made is later forfeited, the partnership shall make forfeiture allocations in the year of the forfeiture; and (2) all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a § 83(b) election has been made are recognized under § 704(b). Proposed § 1.704–1(b)(4)(xii)(*e*) provides that proposed § 1.704–1(b)(4)(xii)(*b*) does not apply to allocations of partnership items made with respect to a substantially nonvested interest for which the holder has made a § 83(b) election if, at the time of the § 83(b) election, there is a plan that the interest will be forfeited. In determining whether there is a plan that the interest will be forfeited, the Commissioner will consider all of the facts and circumstances (including the tax status of the holder of the forfeitable compensatory partnership interest).

Proposed § 1.704–1(b)(4)(xii)(*c*) defines forfeiture allocations as allocations to the service provider (consisting of a *pro rata* portion of each item) of gross income and gain or gross deduction and loss (to the extent such items are available) for the taxable year of the forfeiture in a positive or negative amount equal to (1) the excess (not less than zero) of (a) the amount of the distributions (including deemed distributions under § 752(b) and the adjusted tax basis of any property so distributed) to the partner with respect to the forfeited partnership interest (to the extent such distributions are not taxable under § 731), over (b) the amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under § 752(a)) to the partnership with respect to the forfeited partnership interest, minus (2) the cumulative net income (or loss) allocated to the partner with respect to the forfeited partnership

interest. Proposed § 1.704–1(b)(4)(xii)(*d*) provides that for purposes of proposed § 1.704–1(b)(4)(xii)(*c*), items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts.

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Proposed § 1.721–1(b)(1) provides that § 721 generally does not apply to the transfer of a partnership interest in connection with the performance of services. Such a transfer constitutes a transfer of property to which § 83 and the regulations thereunder apply. However, under proposed § 1.721–1(b)(2), except as provided in § 83(h) or § 1.83–6(c), no gain or loss is recognized by a partnership upon: (i) the transfer or substantial vesting of a compensatory partnership interest, or (ii) the forfeiture of a compensatory partnership interest.

Proposed § 1.761–1(b) provides that if a partnership interest is transferred in connection with the performance of services, and that partnership interest is substantially nonvested (within the meaning of § 1.83–3(b)), then the holder of the partnership interest is not treated as a partner solely by reason of holding the interest, unless the holder makes an election with respect to the interest under § 83(b).

Rev. Proc. 93–27, 1993–2 C.B. 343, provides generally that if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership. The revenue procedure does not apply if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of § 7704(b).

Rev. Proc. 2001–43, 2001–2 C.B. 191, clarifies Rev. Proc. 93–27 and provides that, for purposes of Rev. Proc. 93–27, if a partnership grants a substantially nonvested profits interest in the partnership to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that: (1) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest; (2) upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and (3) all other conditions of Rev. Proc. 93–27 are satisfied.

SECTION 3. SCOPE

.01 *In General*. The Safe Harbor in section 4 of this revenue procedure applies to any Safe Harbor Partnership Interest transferred by a partnership if the transfer is made during the period in which the Safe Harbor Election is in effect (whether or not the Safe Harbor Partnership Interest is substantially vested on the date of transfer). Thus, for example, sections 4.02 through 4.04 of this revenue procedure apply to a Safe Harbor Partnership Interest that is transferred during the period in which the Safe Harbor Election is in effect, even if that Safe Harbor Partnership Interest does not become substantially vested until after the Safe Harbor Election is terminated, a § 83(b) election is made after the Safe Harbor Election is terminated, or that Safe Harbor Partnership Interest is forfeited after the Safe Harbor Election is terminated. Further, a Safe Harbor Election is binding on the partnership, all of its partners, and the service provider. The Safe Harbor includes all of the rules set forth in section 4 of this revenue procedure, and a partnership, its partners, and the service provider may not choose to apply only certain of the rules in section 4 of this revenue procedure or to apply the Safe Harbor only to certain partners, service providers, or partnership interests.

.02 *Safe Harbor Partnership Interest*. (1) Except as otherwise provided in section 3.02(2) of this revenue procedure, a Safe Harbor Partnership Interest is any interest in a partnership that is transferred to a service provider by such partnership in connection with services provided to the partnership (either before or after the formation of the partnership), provided that the interest is not (a) related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (b) transferred in anticipation of a subsequent disposition, or (c) an interest in a publicly traded partnership within the meaning of § 7704(b). Unless it is established by clear and convincing evidence that the partnership interest was not transferred in anticipation of a subsequent disposition, a partnership interest is presumed to be transferred in anticipation of a subsequent disposition for purposes of the preceding clause (b) if the partnership interest is sold or disposed of within two years of the date of receipt of the partnership interest (other than a sale or disposition by reason of death or disability of the service provider) or is the subject, at any time within two years of the date of receipt, of a right to buy or sell regardless of when the right is exercisable (other than a right to buy or sell arising by reason of the death or disability of the service provider). For the purposes of this revenue procedure, "disability" means a condition which causes a service provider to be unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment expected to result in death or to last for a continuous period of not less than 12 months.

(2) An interest in a partnership is not a Safe Harbor Partnership Interest unless at the date of transfer the requirements of section 3.03 of this revenue procedure are satisfied and a Safe Harbor Election has not terminated pursuant to section 3.04 of this revenue procedure. For the first taxable year that a partnership is subject to a Safe Harbor Election, a partnership interest may be a Safe Harbor Partnership Interest if a Safe Harbor Election is attached to the partnership tax return for the taxable year including the date of transfer, provided that the other requirements of section 3.03 of this revenue procedure are satisfied on or before the date of such transfer.

.03 *Required Conditions for Safe Harbor Election*. In order to effect and main-

tain a valid Safe Harbor Election, the following conditions must be satisfied:

(1) The partnership must prepare a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the Safe Harbor described in Rev. Proc. 200X–XX apply irrevocably with respect to all partnership interests transferred in connection with the performance of services while the Safe Harbor Election remains in effect. The Safe Harbor Election must specify the effective date of the Safe Harbor Election, and the effective date for the Safe Harbor Election may not be prior to the date that the Safe Harbor Election is executed. The Safe Harbor Election must be attached to the tax return for the partnership for the taxable year that includes the effective date of the Safe Harbor Election.

(2) Except as provided in section 3.03(3) of this revenue procedure, the partnership agreement must contain provisions that are legally binding on all of the partners stating that (a) the partnership is authorized and directed to elect the Safe Harbor described in this revenue procedure, and (b) the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the Safe Harbor described in this revenue procedure with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. If a partner that is bound by these provisions transfers a partnership interest to another person, the requirement that each partner be bound by these provisions is satisfied only if the person to whom the interest is transferred assumes the transferring partner's obligations under the partnership agreement. If an amendment to the partnership agreement is required, the amendment must be effective before the date on which a transfer occurs for the Safe Harbor to be applied to such transfer.

(3) If the partnership agreement does not contain the provisions described in section 3.03(2) of this revenue procedure, or the provisions are not legally binding on all of the partners of the partnership, then each partner in a partnership that transfers a partnership interest in connection with the performance of services must execute a document containing provisions that are legally binding on each partner stating that (a) the partnership is authorized and directed to elect the Safe Harbor described in this revenue procedure, and (b) the partner agrees to comply with all requirements of the Safe Harbor described in this revenue procedure with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. Each person classified as a partner must execute the document required by this paragraph (3), and the document must be effective, before the date on which a transfer occurs, for the Safe Harbor to be applied to such transfer. If a partner who has submitted the required document transfers a partnership interest to another person, the condition that each partner submit the necessary document is satisfied only if the person to whom the interest is transferred either submits the required document or assumes the transferring partner's obligations under a document required by this paragraph that was previously submitted with respect to the transferred interest.

.04 *Termination of Safe Harbor Election*. A Safe Harbor Election continues in effect until terminated. A Safe Harbor Election terminates automatically on the date that a partnership fails to satisfy the conditions and requirements described in sections 3.02 and 3.03 of this revenue procedure. A Safe Harbor Election also terminates automatically in the event that the partnership, a partner, or service provider reports income tax effects of a Safe Harbor Partnership Interest in a manner inconsistent with the requirements of this revenue procedure, including a failure to provide appropriate information returns. A partnership may affirmatively terminate a Safe Harbor Election by preparing a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, indicating that the partnership, on behalf of the partnership and each of its partners, is revoking its Safe Harbor Election under Rev. Proc. 200X–XX and the effective date of the revocation, provided that the effective date may not be prior to the date the election to terminate is executed. Such termination election must be attached to the tax return for the partnership for the taxable year that includes the effective date of the election. The rules of the Safe Harbor in section 4 of this revenue procedure do not apply to any partnership interests transferred on or after the date of a termination of the Safe Harbor Election under this paragraph but continue to apply to any Safe Harbor Partnership Interests transferred while the Safe Harbor Election was in effect.

.05 *Election After Termination*. If a partnership has made a Safe Harbor Election and if such Safe Harbor Election has been terminated under section 3.04 of this revenue procedure, then, absent the consent of the Commissioner, the partnership (and any successor partnerships) are not eligible to make a Safe Harbor Election for any taxable year that begins before the fifth calendar year after the calendar year during which such termination occurs. For purposes of this paragraph, a successor partnership is any partnership that (1) on the date of termination, is related (within the meaning of § 267(b) or § 707(b)) to the partnership whose Safe Harbor Election has terminated (or, if the partnership whose Safe Harbor Election has terminated does not exist on the date of termination would be related if it existed on such date), and (2) acquires (either directly or indirectly) a substantial portion of the assets of the partnership whose Safe Harbor Election has terminated.

.06 *Recordkeeping Requirement*. Under proposed § 1.83–3(l), the partnership is required to keep as records: (1) a copy of the Safe Harbor Election submitted by the partnership to the Service under section 3.03(1) of this revenue procedure, and (2) if applicable, the original of each document submitted to the partnership by a partner under section 3.03(3) of this revenue procedure. If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the Safe Harbor Election under section 3.04 of this revenue procedure.

SECTION 4. SAFE HARBOR

.01 *Safe Harbor*. For purposes of § 83, the rules in sections 4.02 through 4.04 of this revenue procedure apply to any Safe Harbor Partnership Interest for which a Safe Harbor Election is in effect.

.02 *Liquidation Value*. Under the Safe Harbor, the fair market value of a Safe Harbor Partnership Interest is treated as being

equal to the liquidation value of that interest. For this purpose, liquidation value is determined without regard to any lapse restriction (as defined at § 1.83–3(i)) and means the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated.

.03 *Vesting*. Under the Safe Harbor, a Safe Harbor Partnership Interest is treated as substantially vested if the right to the associated capital account balance equivalent is not subject to a substantial risk of forfeiture or the interest is transferable. A Safe Harbor Partnership Interest is treated as substantially nonvested only if, under the terms of the interest at the time of the transfer, the interest terminates and the holder may be required to forfeit the capital account balance equivalent credited to the holder under conditions that would constitute a substantial risk of forfeiture, and the interest is not transferable. For these purposes, the capital account balance equivalent is the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately prior to the forfeiture, the interest vested and the partnership sold all of its assets (including goodwill, going concern value, or any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated. Notwithstanding the previous sentence, a Safe Harbor Partnership Interest will not be considered substantially nonvested if the sole portion of the capital account balance equivalent forfeited is the excess of the capital account balance equivalent at the date of termination of services over the capital account balance equivalent at the end of the prior partnership tax year or any later date before the date of termination of services.

.04 *Forfeiture Subsequent to § 83(b) Election*. If a Safe Harbor Partnership Interest with respect to which a § 83(b) election has been made is forfeited, the service provider must include as ordinary income in the taxable year of the forfeiture an amount equal to the excess, if any, of (1) the amount of income or gain that the partnership would be required to allocate to the service provider under proposed § 1.704–1(b)(4)(xii) if the partnership had unlimited items of gross income and gain, over (2) the amount of income or gain that the partnership actually allocated to the service provider under proposed §1.704–1(b)(4)(xii).

SECTION 5. APPLICATION OF SAFE HARBOR TO SERVICE PROVIDER AND SERVICE RECIPIENT

.01 *Application of Safe Harbor to the Service Provider*. Under the Safe Harbor, the service provider recognizes compensation income upon the transfer of a substantially vested Safe Harbor Partnership Interest in an amount equal to the liquidation value of the interest, less any amount paid for the interest. If the service provider receives a Safe Harbor Partnership Interest that is substantially nonvested, does not make an election under § 83(b), and holds the interest until it substantially vests, the service provider recognizes compensation income in an amount equal to the liquidation value of the interest on the date the interest substantially vests, less any amount paid for the interest. If the service provider receives a Safe Harbor Partnership Interest that is substantially nonvested and makes an election under § 83(b), the service provider recognizes compensation income on the date of transfer equal to the liquidation value of the interest, determined as if the interest were substantially vested, pursuant to the rules of § 83(b) and § 1.83–2, less any amount paid for the interest.

.02 *Application of Safe Harbor to the Service Recipient*. Under § 83(h), the service recipient generally is entitled to a deduction equal to the amount included as compensation in the gross income of the service provider under § 83(a), (b), or (d)(2), but only to the extent the amount meets the requirements of § 162 or § 212. Under the Safe Harbor, the amount included in the service provider's gross income in accordance with section 4.02 of this revenue procedure is considered the amount included as compensation in the gross income of the service provider under § 83(a) or (b) for purposes of § 83(h). The deduction generally is allowed for the taxable year of the partnership in which or with which ends the taxable year of the service provider in which the amount is included in gross income as compensation. However, in accordance with § 1.83–6(a)(3), where the deduction relates to the transfer of substantially vested property, the deduction is available in accordance with the service recipient's method of accounting.

SECTION 6. EXAMPLES

The following facts apply for all of the examples below:

SP is an individual with a calendar year taxable year. *PRS* is a partnership with a calendar year taxable year. Except as otherwise stated, *PRS*'s partnership agreement provides for all partnership items to be allocated to the partners in proportion to the partners' interests in the partnership. *PRS*'s partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with § 1.704–1(b)(2)(iv), that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership. All allocations and distributions to all parties are not recast under § 707(a)(2), and § 751(b) does not apply to any distribution. The partnership, its members, and the service providers elect the Safe Harbor provided in section 4 of this revenue procedure and file all affected returns consistent with the Safe Harbor, and each partnership interest transferred constitutes a Safe Harbor Partnership Interest under section 3.02 of this revenue procedure. The issuance of the partnership interest in each example is not required to be capitalized under the rules of § 263 or other applicable provision of the Code. In examples in which the partnership interest transferred to the service provider is not substantially vested, there is not a plan that the service provider will forfeit the partnership interest.

(1) *Example 1: Substantially Vested Profits Interest*

Facts: *PRS* has two partners, *A* and *B*, each with a 50% interest in *PRS*. On March 1, 2005, *SP* agrees to perform services for the partnership in exchange for a partnership interest. Under the terms of the partnership agreement, *SP* is entitled to 10% of the future profits and losses of *PRS*, but is not entitled to any of the partnership's capital as of the date of transfer.

Although *SP* must surrender the partnership interest upon termination of services to the partnership, *SP* will not surrender any share of the profits accumulated through the end of the partnership taxable year preceding the partnership taxable year in which *SP* terminates services.

Conclusion: Under section 4.03 of this revenue procedure, *SP*'s interest in *PRS* is treated as substantially vested at the time of transfer. Under section 4.02 of this revenue procedure, the fair market value of the interest for purposes of § 83 is treated as being equal to its liquidation value (zero). Therefore, *SP* does not recognize compensation income under § 83(a) as a result of the transfer, *PRS* is not entitled to a deduction, and *SP* is not entitled to a capital account balance.

(2) *Example 2: Substantially Vested Interest*

Facts: *PRS* has two partners, *A* and *B*, each with a 50% interest in *PRS*. On March 1, 2005, *SP* pays the partnership $10 and agrees to perform services for the partnership in exchange for a 10% partnership interest that is treated as substantially vested under section 4.03 of this revenue procedure. Immediately before *SP*'s $10 payment to *PRS* and the transfer of the partnership interest to *SP* in connection with the performance of services, the value of the partnership's assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) is $990.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value of *SP*'s interest in *PRS* at the time the interest becomes substantially vested is treated as being equal to its liquidation value at that time for purposes of § 83. Therefore, in 2005, *SP* includes $90 ($100 liquidation value less $10 amount paid for the interest) as compensation income under § 83(a), *PRS* is entitled to a deduction of $90 under § 83(h), and *SP*'s initial capital account is $100 ($90 included in income plus $10 amount paid for the interest).

(3) *Example 3: Substantially Nonvested Interest; No § 83(b) Election; Pre-Existing Partner*

Facts: *PRS* has two partners, *A* and *SP*, each with a 50% interest in *PRS*. On December 31, 2004, *SP* agrees to perform services for the partnership in exchange for a 10% increase in *SP*'s interest in the partnership from 50% to 60%. *SP* is not required to pay any amount in exchange for the additional 10% interest. Under the terms of the partnership agreement, if *SP* terminates services on or before January 1, 2008, *SP* forfeits any right to any share of accumulated, undistributed profits with respect to the additional 10% interest. The partnership interest transferred to *SP* is not transferable and no election is made under § 83(b). *SP* continues performing services through January 1, 2008. *PRS* has taxable income of $500 in 2005 and $1,000 in each of 2006 and 2007. No distributions are made to *A* or *SP* during such period. On January 1, 2008, the value of the partnership's assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) is $3,500.

Conclusion: Under section 4.03 of this revenue procedure, the 10% partnership interest transferred to *SP* on December 31, 2004, is treated as substantially nonvested at the time of transfer. Because a § 83(b) election is not made, *SP* does not include any amount as compensation income attributable to the transfer, and correspondingly, *PRS* is not entitled to a deduction under § 83(h).

In accordance with the partnership agreement, *PRS*'s taxable income for 2005 is allocated $250 to *A* and $250 to *SP*, and *PRS*'s taxable income for each of 2006 and 2007 is allocated $500 to *A* and $500 to *SP*.

On January 1, 2008, *SP*'s additional 10% interest in *PRS* is treated as becoming substantially vested under section 4.03 of this revenue procedure. At that time, the additional 10% interest in the partnership has a liquidation value of $350 (10% of $3,500). Under section 4.02 of this revenue procedure, the fair market value of the interest at the time it becomes substantially vested is treated as being equal to its liquidation value at that time for purposes of § 83. Therefore, in 2008, *SP* includes $350 as compensation income under § 83(a), *PRS* is entitled to a deduction of $350 under § 83(h), and *SP*'s capital account is increased by $350.

(4) *Example 4: Substantially Nonvested Interest; No § 83(b) Election*

Facts: *PRS* has two partners, *A* and *B*, each with a 50% interest in *PRS*. On December 31, 2004, *SP* pays the partnership $10 and agrees to perform services for the partnership in exchange for a 10% partnership interest. Under the terms of the partnership agreement, if *SP* terminates services on or before January 1, 2008, *SP* forfeits any rights to any share of accumulated, undistributed profits, but is entitled to a return of *SP*'s $10 initial contribution. *SP*'s partnership interest is not transferable and no election is made under § 83(b). *SP* continues performing services through January 1, 2008. *PRS* earns $500 of taxable income in 2005, and $1,000 in each of 2006 and 2007. *A* and *B* each receive distributions of $225 in 2005, but neither *A* nor *B* receive distributions in 2006 and 2007. *PRS* transfers $50 to *SP* in 2005, but does not make any transfers to *SP* in 2006 or 2007. On January 1, 2008, *SP*'s partnership interest has a liquidation value of $300 (taking into account the unpaid partnership income credited to *SP* through that date).

Conclusion: Under section 4.03 of this revenue procedure, *SP*'s partnership interest is treated as substantially nonvested at the time of transfer. Because a § 83(b) election is not made, *SP* does not include any amount as compensation income attributable to the transfer and, correspondingly, *PRS* is not entitled to a deduction under § 83(h). Under proposed § 1.761–1(b), *SP* is not a partner in *PRS*; therefore, none of *PRS*'s taxable income for the years in which *SP*'s interest is substantially nonvested may be allocated to *SP*. Rather, *PRS*'s taxable income is allocated exclusively to *A* and *B*. In addition, the $50 paid by *PRS* to *SP* in 2005 is compensation income to *SP*, and *PRS* is entitled to a deduction of $50 under § 162 in accordance with its method of accounting.

On January 1, 2008, *SP*'s interest in *PRS* is treated as becoming substantially vested under section 4.03 of this revenue procedure. Under section 4.02 of this revenue procedure, the fair market value of the interest at the time the interest becomes substantially vested is treated as being equal to its liquidation value at that time for § 83 purposes. Therefore, in 2008, *SP* includes $290 ($300 liquidation value less $10 amount paid for the interest) as compensation income under § 83(a), *PRS* is entitled to a $290 deduction, and *SP*'s capital account is increased to $300 ($290 included in income plus $10 amount paid for the interest).

(5) *Example 5: Substantially Nonvested Interest; § 83(b) Election*

Facts: The facts are the same as in *Example 4*, except that *SP* makes an election under § 83(b) with respect to *SP*'s interest in *PRS*. The liquidation value of the interest is $100 at the time the interest in *PRS* is transferred to *SP*. *SP* continues performing services through January 1, 2008.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value (disregarding lapse restrictions) of *SP*'s interest in *PRS* at the time of transfer is treated as being equal to its liquidation value (disregarding lapse restrictions) at that time for § 83 purposes. Because a § 83(b) election is made, in 2004 *SP* includes $90 ($100 liquidation value less $10 amount paid for the interest) as compensation income, *PRS* is entitled to a $90 deduction, and *SP*'s initial capital account is $100 ($90 included in *SP*'s income plus $10 amount paid for the interest). Under proposed § 1.761–1(b), as a result of *SP*'s election under § 83(b), *SP* is treated as a partner starting from the date of the transfer of the interest to *SP*. Accordingly, *SP* includes in 2005 taxable income *SP*'s $50 distributive share of *PRS* income, and the $50 payment to *SP* by *PRS* in 2005 is a partnership distribution under § 731. *SP* includes in 2006 and 2007 taxable income *SP*'s $100 distributive shares of *PRS* income for those years.

(6) *Example 6: Substantially Nonvested Interest; § 83(b) Election; Forfeiture; Net Profit*

Facts: The facts are the same as in *Example 5*, except that *SP* terminates services on September 30, 2007, and is repaid the $10 that *SP* paid for the *PRS* interest in 2004. The partnership agreement provides that if *SP*'s partnership interest is forfeited, *SP*'s distributive share of all partnership items (other than forfeiture allocations) will be zero with respect to the interest for the taxable year of the partnership in which the interest is forfeited.

Conclusion: The tax consequences for 2004 through 2006 are the same as in *Example (5)*. As a result of the forfeiture in 2007, *PRS* is required under § 1.83–6(c) to include in gross income $90 (the amount of the allowable deduction on the transfer of the interest to *SP*). In accordance with the partnership agreement, *PRS* also makes forfeiture allocations in 2007 to offset partnership income and loss that was allocated to *SP* and partnership distributions to *SP* prior to the forfeiture. Cumulative net income of $150 was allocated to *SP* prior to the forfeiture ($50 in 2005 and $100 in 2006) and *SP* received a total of $60 of distributions from *PRS* ($50 in 2005 and $10 in 2007 (the repayment of *SP*'s initial contribution to *PRS*)). Under proposed § 1.704–1(b)(4)(xii), the total forfeiture allocations to *SP* is $100 of partnership loss and deduction, the difference between $50 ($60 of distributions to *SP* less $10 of contributions to *PRS* by *SP*) and $150 (cumulative net income allocated to *SP*). Pursuant to the partnership agreement, none of the partnership income for the year 2007 is allocated to *SP*. In accordance with § 83(b)(1) (last sentence), *SP* does not receive a deduction or capital loss for the amount ($90) that was included as *SP*'s compensation income as a result of the election under § 83(b).

(7) *Example 7: Substantially Nonvested Interest; § 83(b) Election; Forfeiture; Net Loss*

Facts: *PRS* has two partners, *A* and *B*, each with a 50% interest in *PRS*. On December 31, 2004, *SP* pays the partnership $10 and agrees to perform services for the partnership in exchange for a 10% partnership interest. Under the terms of the partnership agreement, if *SP* terminates services before January 1, 2008, *SP* forfeits any right to any share of accumulated, undistributed profits, but is entitled to a return of *SP*'s $10 initial contribution. *SP*'s partnership interest is not transferable. The partnership agreement provides that if *SP*'s partnership interest is forfeited, *SP*'s distributive share of all partnership items (other than forfeiture allocations) will be zero with respect to the interest for the taxable year of the partnership in which the interest is forfeited. At the time of the transfer, the liquidation value of the 10% partnership interest is $100, and *SP* makes an election under § 83(b) with respect to the interest. In 2005, *PRS* earns $500 of taxable income, which is allocated and distributed $225 to each of A and B and $50 to *SP*. In 2006, *PRS* has net taxable loss of $1,000, $100 of which is allocated to *SP*. *PRS* does not make any distributions in 2006. *PRS* has no items of income, gain, loss, or deduction in 2007, other than gross income recognized under § 1.83–6(c). *SP* terminates services on September 30, 2007, and is repaid the $10 that *SP* paid for the *PRS* interest in 2004. *PRS* does not make any distributions in 2007, other than the return of *SP*'s $10 contribution.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value (disregarding lapse restrictions) of *SP*'s interest in *PRS* at the time of transfer is treated as being equal to its liquidation value (disregarding lapse restrictions) at that time for purposes of § 83. Because a § 83(b) election is made, *SP* includes as compensation income in 2004 $90 ($100 liquidation value less $10 amount paid for the interest), *PRS* is entitled to a $90 deduction under § 83(h), and *SP*'s initial capital account is $100 ($90 compensation income plus $10 amount paid for the interest). Under proposed § 1.761–1(b), as a result of *SP*'s election under § 83(b), *SP* is treated as a partner starting from the date of the transfer of the interest to *SP*. Accordingly, *SP* includes in 2005 taxable income *SP*'s $50 distributive share of *PRS*'s income, and the $50 payment to *SP* in 2005 is a partnership distribution under § 731. *SP* includes in computing 2006 taxable income *SP*'s $100 distributive share of *PRS*'s loss.

As a result of the forfeiture in 2007, *PRS* is required under § 1.83–6(c) to include in gross income $90 (the amount of the allowable deduction on the transfer of the interest to *SP*). In accordance with the partnership agreement, *PRS* also makes forfeiture allocations in 2007 to offset partnership income and loss that was allocated to *SP* and partnership distributions to *SP* prior to the forfeiture. Cumulative net loss of $50 was allocated to *SP* prior to the forfeiture ($50 of income in 2005 and $100 of loss in 2006) and *SP* received a total of $60 of partnership distributions ($50 in 2005 and $10 in 2007 (the repayment of *SP*'s initial contribution to *PRS*)). If *PRS* had unlimited items of gross income and gain, the total forfeiture allocations to *SP* under proposed § 1.704–1(b)(4)(xii) would be $100 of partnership income and gain, the difference between $50 ($60 distributions to *SP* less $10 of contributions to *PRS* by *SP*) and -$50 (cumulative net loss allocated to *SP*). However, *PRS*'s only income in 2007 is the $90 of income recognized by *PRS* under § 1.83–6(c), all of which must be used to make forfeiture allocations to *SP*. Under section 4.04 of this revenue procedure, in 2007, *SP* must include in ordinary income $10 (the difference between the forfeiture allocations that would be required under proposed § 1.704–1(b)(4)(xii) if *PRS* had an unlimited amount of gross income and gain, $100, and the actual forfeiture allocations to *SP*, $90). *PRS* is not entitled to a deduction for the amount ($10) that *SP* is required to include in income under section 4.04 of this revenue procedure.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 93–27, 1993–2 C.B. 343, and Rev. Proc. 2001–43, 2001–2 C.B. 191, are obsoleted.

Deductions for Entertainment Use of Business Aircraft

Notice 2005–45

This notice provides interim guidance to taxpayers on the limitation under § 274(e) of the Internal Revenue Code on the deductible amount of trade or business expenses for use of a business aircraft for entertainment. Section 274(e) was amended by § 907 of the American Jobs Creation Act of 2004 (AJCA), effective for amounts incurred after October 22, 2004. The rules provided in this notice apply until regulations are effective.

A. BACKGROUND

Under § 274(a)(1)(A), no deduction is allowed for an activity generally considered to be entertainment, amusement, or recreation, unless the taxpayer establishes that the activity is directly related to or (in certain cases) associated with the active conduct of the taxpayer's trade or business. Section 274(a)(1)(B) disallows deductions for facilities used in connection with entertainment, amusement, or recreational activity, regardless of connection to the taxpayer's trade or business.

Section 1.274–2(b)(1) of the Income Tax Regulations provides that entertainment means any activity of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips. Similar activities relating solely to the taxpayer's family also may constitute entertainment. Entertainment may include an activity that satisfies the personal, living, or family needs of an individual, such as providing food and beverages or a hotel suite to a business customer or the customer's family. Entertainment does not include activities, however, that are clearly not regarded as constituting entertainment, such as the provision of supper money by an employer to an employee working overtime, the maintenance of a hotel room by an employer for lodging of employees while in business travel status, or the use of an automobile in the active conduct of a trade or business even though also used for routine personal purposes such as commuting to and from work. Under § 1.274–2(b)(1)(ii), an objective test is used to determine whether an activity is of a type generally considered to constitute entertainment.

Section 274(e) provides exceptions to the general disallowance provisions of § 274(a). Prior to amendment by the AJCA, § 274(e)(2) excepted expenses from § 274(a) "to the extent that the expenses are treated by the taxpayer" as compensation to the employee/recipient of the entertainment activity. Section 274(e)(9) similarly excepted expenses to the extent that the expenses are treated by the taxpayer as income to persons who are not employees.

Section 274(o) provides that the Secretary shall prescribe regulations necessary to carry out the purposes of the section.

Generally, § 1.61–21(b) requires an employee to include in gross income the fair market value of a fringe benefit, such as an entertainment flight (reduced by any reimbursement or statutory exclusion). For employee flights on employer-provided noncommercial aircraft, § 1.61–21(g) provides that an employer may value such flights using the Standard Industry Fare Level (SIFL) formula. Under § 1.61–21(g)(14)(i), an employer that uses the SIFL formula in a calendar year to value any flight provided to an employee during a calendar year must use the SIFL formula to value all flights provided to employees during that calendar year. The fringe benefit rules under § 1.61–21(g) generally apply to all service providers, including employees, independent contractors, partners, and directors.

The regulations do not permit valuation of a flight by reference to the employer's costs.

Ann. 85–113, 1985–31 I.R.B. 31, allows an employer to elect the frequency at which in-kind fringe benefits are treated as paid. The benefits must be treated as paid no later than the end of each calendar year, but in-kind fringe benefits provided during the last two months of a calendar year may be treated as paid during the subsequent calendar year. See Ann. 85–113, sections 1 and 5(a).

In *Sutherland Lumber-Southwest, Inc. v. Comm'r*, 114 T.C. 197 (2000), *aff'd* 255 F.3d 495 (8th Cir. 2001), acq. AOD 2002–02 (Feb. 11, 2002), the Tax Court held that the amount a taxpayer may deduct for the cost of entertainment-related flights under the § 274(e)(2) exception is not limited to the amount included in the income of the employees and corporate officers who took the flights. Rather, the court held that a taxpayer may deduct the full cost of an employee's or officer's non-business flight on the taxpayer's aircraft if the taxpayer includes in the recipient's income the value of the flights computed under the rules of § 1.61–21. As a result, a deduction greater than the amount included in the recipient's income was allowable.

The ACJA amendment to § 274(e)(2) and (9) is intended to overturn *Sutherland Lumber-Southwest, Inc. v. Comm'r*. H.R. Conf. Rep. No. 108–755, at 798 (2004). Specifically, as amended by § 907 of the AJCA, the § 274(e)(2) and (9) exceptions to the § 274(a) disallowance apply in the case of a "specified individual" only "to the extent that the expenses do not exceed the amount of expenses" that are treated as compensation to the specified individual. A specified individual is any individual who is subject to the requirements of § 16(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p(a)) with respect to the taxpayer, or who would be subject to those requirements if the taxpayer were an issuer of equity securities referred to in that section. Section 274(e)(2)(B).

Thus, in the case of a specified individual, the § 274(e)(2) and (9) exceptions apply only to the extent that a taxpayer treats as compensation to the specified individual an amount equal to or greater than the amount of deductible entertainment expenses allocable to entertainment provided to the specified individual. Expenses allocable to entertainment provided to the specified individual that are not treated as compensation to the specified individual are disallowed.

This notice specifically addresses expenses paid or incurred in connection with the use of aircraft as entertainment. Section 274(e)(2) and (9), however, apply to all expenses subject to § 274(a). Taxpayers may apply the principles of this notice to expenses paid or incurred in connection with other entertainment activities.

B. APPLICATION

(1) *In general*

In general, the use of an aircraft for an employee's or other recipient's entertainment, amusement, or recreation is subject to § 274(a) unless excepted by § 274(e). Expenses for entertainment use of an aircraft by a specified individual are disallowed except to the extent of the amount treated as compensation to the specified individual, as provided in this notice. The amount disallowed with regard to a specific flight also is reduced by any amount that a specified individual reimburses the taxpayer for that flight.

(2) *Use of aircraft for entertainment*

Whether an aircraft is used for entertainment of a specified individual is determined without regard to the ownership of the aircraft. Therefore, the costs of leased or chartered aircraft are subject to disallowance under § 274(a) (unless excepted by § 274(e)) and this notice. Furthermore, § 274(a) and (e) and this notice apply to the costs of aircraft operated on a regular schedule or used for *bona fide* security concerns (as provided in § 1.132–5(m)).

(3) *Specified individuals*

A "specified individual" is either an individual who is subject to § 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer, or an individual who would be subject to § 16(a) if the taxpayer were an issuer of equity securities referred to in that section. "Specified individual" includes every person who (a) is the direct or indirect beneficial owner of more than 10 percent of any class of any registered equity security (other than an exempted security), (b) is a director or officer of the issuer of the security, (c) would be the direct or indirect beneficial owner of more than 10 percent of any class of a registered equity security if the taxpayer were an issuer of equity securities, or (d) is comparable to an officer or director of an issuer of equity securities. Thus, a "specified individual" is an officer, director, or more than 10% owner of a corporation taxed under subchapter C or subchapter S, or a personal service corporation. For partnership purposes, "specified individual" includes any partner that holds a more than 10% equity interest in the partnership, general partner, officer, or managing member of a partnership. "Specified individual" also includes a director or officer of a tax-exempt entity.

The provisions of this notice apply to the use of an aircraft for the entertainment of a specified individual of a party related to the taxpayer within the meaning of § 267(b) or § 707(b). Thus, if X and Y are related corporations within the meaning of § 267(b) and Y provides entertainment use of an aircraft to A, who is a specified individual as to X, Y's costs are disallowed (except to the extent treated as compensation to A or reimbursed by A) under § 274(e)(2)(B).

For purposes of this notice, a specified individual is the recipient of entertainment provided to a spouse or family member of the specified individual or to another person because of the person's relationship to the specified individual. See § 1.61–21(a)(4). Thus, costs allocable to entertainment provided to a spouse, family member, or other person are attributed to the specified individual for purposes of determining the amount of disallowed costs. As used hereafter in this notice, the term "specified individual" includes any person to whom a taxpayer has provided entertainment that is attributable to a specified individual under this paragraph.

(4) *Expenses of aircraft subject to disallowance*

For purposes of calculating the amount of expenses for entertainment use of an aircraft that are disallowed (except to the extent treated as compensation to or reimbursed by a specified individual) under § 274(e)(2)(B) or (9), taxpayers must take into account all of the expenses of maintaining and operating the aircraft (all fixed

and operating costs). These expenses include, but are not limited to, fuel costs; salaries for pilots, maintenance personnel, and other personnel assigned to the aircraft; meal and lodging expenses of flight personnel; take-off and landing fees; costs for maintenance and maintenance flights; costs of on board refreshments, amenities, or gifts; hangar fees (at home or away); management fees; depreciation; amounts deductible under § 179; in the case of chartered aircraft, all costs billed for the charter (including amounts for flight time, waiting time, fuel, and overnight expenses); and, in the case of leased aircraft or other leased equipment, lease payments.

(5) *Method of allocating expenses to flights*

For purposes of § 274(e)(2)(B) and (9), the total deductible expenses attributable to the aircraft must be allocated to expenses for use of the aircraft for entertainment of specified individuals and expenses for all other uses. A taxpayer must allocate expenses for each taxable year using either occupied seat hours or occupied seat miles flown by the aircraft and must apply the chosen method consistently for all usage for the taxable year. Occupied seat hours or miles is the sum of the hours or miles flown by an aircraft multiplied by the number of seats occupied for each hour or mile. For example, a flight of 6 hours with three passengers aboard results in 18 occupied seat hours. See the special rule for "deadhead" flights, below.

Taxpayers must aggregate all fixed and variable expenses to determine the total expenses paid or incurred during the taxable year and divide the amount of total expenses by total occupied seat hours or occupied seat miles flown to determine the cost per occupied seat hour or occupied seat mile. Taxpayers may calculate the cost per occupied seat hour or occupied seat mile separately for each aircraft or may aggregate the costs of aircraft of similar cost profiles. For example, the costs of a turboprop aircraft may not be aggregated with the costs of a jet aircraft and the costs of a two-engine jet aircraft may not be aggregated with the costs of a four-engine jet aircraft.

The amount disallowed under § 274 is the sum of (a) the cost of each occupied seat hour (or mile) flown by a specified individual for entertainment purposes, less (b) the sum of the amount treated as compensation and the amount reimbursed for each specified individual and each flight. Therefore, to determine the amount subject to disallowance, taxpayers must allocate the costs to the specific entertainment flight provided to a specified individual and compare the cost of each flight to the amount treated as compensation to or reimbursed by the specified individual for that flight.

Example

A taxpayer's aircraft is used for Flights 1, 2, and 3, of 5 hours, 5 hours, and 4 hours, respectively, during the taxpayer's taxable year. On Flight 1, there are four passengers, none of whom are specified individuals or traveling for entertainment. On Flight 2, passengers A and B are specified individuals traveling for entertainment and passengers C and D are not specified individuals or are not traveling for entertainment. On Flight 3, all four passengers (A, B, E, and F) are specified individuals traveling for entertainment. The taxpayer incurs $56,000 in expenses for the operation of the aircraft for the taxable year.

The aircraft is operated for a total of 56 occupied seat hours for the period (four passengers times 5 hours or 20 occupied seat hours for Flight 1, plus four passengers times 5 hours or 20 occupied seat hours for Flight 2, plus four passengers times 4 hours or 16 occupied seat hours for Flight 3). The cost per occupied seat hour is $1,000 ($56,000/56 hours). The total entertainment usage of the aircraft for specified individuals subject to disallowance is 26 occupied seat hours (two passengers for 5 hours each on Flight 2 and four passengers for 4 hours each on Flight 3) and the total cost subject to disallowance is $26,000 (26 occupied seat hours X $1,000).

For purposes of determining the amount disallowed (to the extent not treated as compensation or reimbursed), $5,000 ($1,000 X 5 hours) each is allocable to A and B for Flight 2, and $4,000 ($1,000 X 4 hours) each is allocable to A, B, E, and F for Flight 3.

For Flight 2, the taxpayer treats $1,200 (the fair market value of the flight) as compensation to A, and B reimburses the taxpayer $500. The taxpayer may deduct $1,700 of the cost of Flight 2 allocable to A and B. The deduction for the remaining $8,300 cost allocable to entertainment provided to A and B on Flight 2 is disallowed (with respect to A, $5,000 less the $1,200 treated as compensation, and with respect to B, $5,000 less the $500 reimbursed). For Flight 3, the taxpayer treats $1,300 (the fair market value of the flight) each as compensation to A, B, E, and F. The taxpayer may deduct $5,200 of the cost of Flight 3. The deduction for the remaining $10,800 cost allocable to entertainment provided to A, B, E, and F on Flight 3 is disallowed ($4,000 less the $1,300 treated as compensation to each specified individual).

(6) *Special rule for "deadhead" flights*

For purposes of this notice, an aircraft returning empty from a flight after discharging passengers or traveling empty to pick up passengers (deadheading) is treated as having the same number and character of occupied seat miles or hours as the leg or legs of the trip on which passengers are aboard.

(7) *Allocation of expenses on trips of a specified individual involving both business and entertainment*

The costs of a flight provided to a specified individual that includes a segment or segments for business and for entertainment must be allocated to the business and entertainment use. The entertainment cost is the excess of the total cost of the flights (by occupied seat hours or miles) over the cost of the flights that would have been taken without the entertainment segment or segments.

Example. G, a specified individual, is the sole passenger on an aircraft on a two-hour flight from City A to City B. The flight from City A to City B is for business. G then travels on a three-hour flight from City B to City C for entertainment purposes, and returns from City C to City A on a four-hour flight. G's flights have resulted in nine occupied seat hours (two for the first segment, plus three for the second segment, plus four for the third segment). If G had returned directly to City A from City B, the flights would have resulted in four occupied seat hours. Five occupied seat hours are allocable to G's entertainment use of the aircraft (nine total occupied seat hours less four occupied seat hours). If the taxpayer's cost per occupied seat hour is $1,000, $5,000 must be allocated to G's entertainment use of the aircraft ($1,000 X five occupied seat hours). The amount disallowed is $5,000 less any amount the taxpayer treats as compensation to G or G reimburses the taxpayer for this flight.

(8) *Non-commercial flight valuation consistency rule*

Under § 1.61–21(g)(14)(i), a taxpayer who uses the SIFL formula in a calendar year to value any flight provided to an employee must use the SIFL formula to value all flights provided to employees during that calendar year. The Internal Revenue Service and the Treasury Department plan to amend these regulations to permit taxpayers to value the entertainment use of aircraft by specified individuals under the fair market value rules of § 1.61–21(b), but continue to value flights for other employees and for specified individuals not traveling for entertainment using the SIFL formula. Until regulations are published, taxpayers may rely on this notice to allow this inconsistency in the treatment of specified and non-specified individuals for income inclusion purposes. If the amount treated

as compensation is greater than the amount of the taxpayer's costs (as determined under this notice) for a flight, however, the taxpayer's deduction is limited to the taxpayer's costs.

(9) *Interaction with § 162(m)*

Any amount for the entertainment use of an aircraft that is treated by the taxpayer as compensation to a specified individual who is also a "covered employee" (as defined in § 162(m)(3)) is subject to § 162(m). Thus, to the extent the covered employee's "applicable employee remuneration" (as defined in § 162(m)(4)), including remuneration related to entertainment, exceeds $1,000,000, the taxpayer's deduction is disallowed under § 162(m).

(10) *Costs treated as compensation*

The amount of costs to which this notice applies is reduced by an amount treated as compensation to a specified individual who is an employee of the taxpayer if the amount is treated as compensation for the flight on the taxpayer's income tax return as originally filed and as wages for purposes of chapter 24 (relating to withholding of income tax at the source on wages). See § 1.274–2(f)(2)(iii)(A) and Ann. 85–113. For a specified individual who is not the taxpayer's employee, costs are treated as compensation if the amount for the flight is included in an information return under Part III of subchapter A of chapter 61 (unless not required to be reported under those provisions). See § 1.274–2(f)(2)(iii)(B).

C. REQUEST FOR COMMENTS

The Service and the Treasury Department request comments on issues arising under this notice. Comments should be submitted in writing on or before August 1, 2005, and should include a reference to Notice 2005–45. Comments may be submitted to CC:PA:LPD:PR (Notice 2005–45), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, comments may be submitted electronically via the following e-mail address: *Notice.Comments@irscounsel.treas.gov.* Please include "Notice 2005–45" in the subject line of any electronic communications.

Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2005–45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. All comments are available for public inspection and copying.

D. EFFECTIVE DATE

This notice applies to expenses incurred after June 30, 2005. The Service will not challenge a reasonable method of determining disallowed expenses incurred after October 22, 2004, and before July 1, 2005. Application of this notice to determine disallowed expenses is a reasonable method.

E. TRANSITION RULE FOR REPORTING DISALLOWED EXPENSES

A taxpayer that incurs expenses to which § 274(e), as amended by the AJCA, applies in a taxable year ending after October 22, 2004, but on or before May 27, 2005, may apply the disallowance of expenses for that taxable year against expenses incurred in the taxpayer's first taxable year ending after May 27, 2005. Thus, for example, a calendar year taxpayer may choose to adjust its taxable income either (a) for its 2005 taxable year to reflect the disallowance of expenses to which this notice applies that are incurred after October 22, 2004, and before January 1, 2006, or (b) for its 2004 taxable year to reflect the disallowance of the portion of the expenses incurred after October 22, 2004, and before January 1, 2005, and for its 2005 taxable year to reflect the disallowance of the portion of the expenses incurred after December 31, 2004, and before January 1, 2006.

DRAFTING INFORMATION

The principal author of this notice is Michael A. Nixon of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Mr. Nixon or Christian Wood at (202) 622–4930 (not a toll-free call).

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26 CFR 601.106: Appeals functions.
(Also Part I, §§ 6166, 7479.)

Rev. Proc. 2005–33

SECTION 1. PURPOSE

This revenue procedure provides guidance on exhausting administrative remedies prior to seeking a declaratory judgment pursuant to section 7479 of the Internal Revenue Code. A declaratory judgment may be requested from the United States Tax Court when an executor has made an election under section 6166 to extend the time for payment of estate tax with respect to an interest in a closely held business, and the Internal Revenue Service has (1) made a determination that the election cannot be made with respect to the estate or with respect to any property included therein, (2) failed to make a determination with respect to the estate or with respect to any property included therein within 180 calendar days after the executor's filing of the election, or (3) made a determination that the extension of time for payment under section 6166 has ceased to apply with respect to the estate or with respect to any property included therein.

SECTION 2. DEFINITIONS

For purposes of this revenue procedure—

(1) any reference to "executor" refers to the executor as defined in section 2203;

(2) any reference to "applicant" refers to the person (or persons) authorized to file a petition with the Tax Court pursuant to section 7479;

(3) any reference to "determination" refers to a determination by the Service as to whether an election may be made under section 6166 for one or more closely held business interests or whether a valid election under section 6166 to extend the time for payment has ceased to apply; such term, however, does not include a private letter ruling, technical advice memorandum, or technical expedited advice memorandum issued by the Office of Chief Counsel;

(4) any reference to a "request for a determination" refers to an election filed under section 6166(a) (and, if applicable, an election under section 6166(b)(7), (8) or (10)) or section 6166(h);

(5) any reference to a "preliminary determination letter" refers to a Letter 950 issued by the Service (also known as a 30-day letter or notice of preliminary determination) or a letter issued by the Service Center which is captioned "preliminary determination letter" and which contains a notice of Appeal rights in language similar to that in a Letter 950; and

(6) any reference to a "final determination letter" refers to a Letter 3570, *Notice of Determination As Provided in IRC § 7479 That Extension of Time for Payment Under IRC § 6166 Has Ceased To Apply*, or Letter 3571, *Notice of Determination As Provided in IRC § 7479 That Election Under IRC § 6166 Has Been Denied*, issued by the Service (each of which is also known as a 90-day letter or notice of final determination).

SECTION 3. BACKGROUND

.01 Pursuant to section 6166(a), an executor may elect to pay part or all of the estate tax in two or more (but not exceeding ten) equal installments if: (1) the decedent was a citizen or resident of the United States at the date of death; and (2) the value included in the decedent's gross estate for either (i) an interest in a closely held business or (ii) interests in two or more closely held businesses that are treated as an interest in a single closely held business pursuant to section 6166(c), exceeds 35 percent of the adjusted gross estate. Section 6166(b) sets forth definitions and, in paragraphs (7), (8), and (10), special rules that allow an executor to make an election to pay part or all of the estate tax in installments under section 6166(a) in certain circumstances that would not otherwise qualify for the election under section 6166(a). Generally, the executor must make an election under section 6166(a) (and, if applicable, an election under section 6166(b)(7), (8) or (10)) no later than the due date for filing the estate tax return (including any extensions of time to file). *See* I.R.C. § 6166(d).

.02 Section 6166(e) provides that, if an election was made under section 6166(a) to pay any part of the estate tax in installments and a deficiency is assessed, the deficiency, subject to applicable limitations on the amount of tax deferred, generally will be prorated to the installments already paid or due prior to the date the deficiency is assessed, as well as to the installments not yet due.

.03 After a valid section 6166 election is made, certain events may trigger the acceleration of the deferred estate tax payments. Section 6166(g) identifies events that terminate the extension of time for payment and require the payment of the unpaid portion of the estate tax upon notice and demand.

.04 Under section 6166(h), the executor of an estate may elect to pay in installments an assessed deficiency of estate tax for an estate that qualifies under section 6166(a), even though the executor did not make an election under section 6166(a). The executor must make the section 6166(h) election with respect to the deficiency no later than 60 calendar days after the Service has issued a notice and demand for the payment of that deficiency.

.05 Section 7479 provides that the Tax Court may issue a declaratory judgment in the case of an actual controversy involving a determination by the Service (or a failure of the Service to make a determination within 180 calendar days) with respect to the initial validity of a section 6166 election, or a determination by the Service with respect to the continuing validity of a section 6166 election. Under section 7479(b)(2), however, the Tax Court may not issue a declaratory judgment unless the applicant has exhausted all administrative remedies within the Service. Section 7479(b)(2) further provides that, with respect to a failure of the Service to make a determination, an applicant shall be deemed to have exhausted the applicant's administrative remedies upon the expiration of 180 calendar days after the request for such determination was made, provided that the applicant has taken in a timely manner all reasonable steps to secure that determination.

.06 Rule 210(c) of the Tax Court Rules of Practice and Procedure provides that the Tax Court will not have jurisdiction over an action for declaratory judgment unless the Service has issued a determination letter, or the Service has been requested to make a determination and has failed to do so for a period of at least 180 calendar days after the request for such determination was made. For information relating to the filing of a petition with the Tax Court for a declaratory judgment under section 7479, see Tax Court Rule 211(f).

SECTION 4. EXHAUSTION OF ADMINISTRATIVE REMEDIES

.01 *Actions Required to be Taken.* Section 7479(b)(2) provides that the Tax Court shall not issue a declaratory judgment or decree in any section 7479 proceeding unless the applicant has exhausted all available administrative remedies within the Service. *See also* Tax Court Rule 210(c)(4). The reasonable steps required to be taken by the applicant, whether the petition is based on the Service's determination or the Service's failure to make a determination, are listed below. All of these steps need not be completed by the same person. The actions taken (and notices received) by the executor, as well as any actions taken (and notices received) by others, will be attributed to, and thus deemed to have been performed (or received) by, the applicant.

(1) The executor must timely file (including extensions of time to file granted by the Service) a Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, on behalf of the estate and attach the election to extend the time to pay pursuant to section 6166(a) (and, if applicable, an election under section 6166(b)(7), (8) or (10)). In the case of a deficiency assessed with respect to an estate for which the executor did not make a section 6166 election on the Form 706, if the executor wishes to pay the deficiency in installments, the executor must elect to extend the time to pay the deficiency pursuant to section 6166(h) by filing a notice of election with the Service within 60 calendar days after the date that notice and demand for payment of the deficiency is made.

(a) If the election is tentatively denied in whole or in part, or if the Service proposes under section 6166(g) to terminate an election, the Service will issue a preliminary determination letter to the applicant, advising the applicant of the applicant's right to appeal the determination by requesting a conference with the Service's Appeals Office (an "Appeals conference").

(b) Similarly, if during the Service's examination of the Form 706, the Service concludes that an election should have been denied, the Service will issue a preliminary determination letter to the applicant, advising the applicant of the appli-

cant's right to appeal the determination by requesting an Appeals conference.

(2) The applicant must request, in writing, an Appeals conference within 30 calendar days after the mailing date of the preliminary determination letter, or by such later date for responding to the preliminary determination letter as is agreed to between the applicant and the Service. The applicant must participate fully in an Appeals conference, including, without limitation, submitting all additional information related to the section 6166 determination (if any) that is requested by the Service in connection with (or as a follow-up to) the Appeals conference.

(a) If the applicant does not timely request an Appeals conference and fully participate in any conference that is held, the applicant will not be deemed to have exhausted all administrative remedies.

(b) Appeals conferences may be conducted by telephone, correspondence, face-to-face meetings, or by a combination of these methods.

(c) Upon reaching a final decision, Appeals will issue a final determination letter to the applicant. The determination by Appeals, regarding the estate's initial or continuing eligibility under section 6166, is final and may not be appealed further within the Service.

.02 *When Remedies Deemed Exhausted*. An applicant will be deemed to have exhausted all administrative remedies upon the applicant's completion of the actions in section 4.01 of this revenue procedure and the expiration of a reasonable time for the Service to issue a final determination letter subsequent to the Appeals conference. For this purpose, a reasonable time shall be deemed to have expired on the 61st calendar day after the later of the date of the Appeals conference or the date of receipt by Appeals of the applicant's submission of all additional information requested, if any.

.03 *Remedies Deemed Exhausted Without Appeals Conference*. An applicant who has taken all reasonable steps to secure the determination as provided in section 4.01 of this revenue procedure will be deemed to have exhausted all administrative remedies within the Service for purposes of section 7479 in the following situations:

(1) upon the issuance of a final determination letter, if the applicant did not previously receive a preliminary determination letter, provided that the failure to receive the preliminary determination letter was not due to actions or inactions of the applicant (such as a failure to supply requested information or a current mailing address to the Service);

(2) upon the expiration of 180 calendar days after the date on which the request for a determination was made, if the applicant has received neither a preliminary determination letter nor a final determination letter within that period, provided that the failure to receive any such letter was not due to actions or inactions of the applicant; or

(3) upon the expiration of a reasonable period of time that is not less than 61 calendar days after a timely request for an Appeals conference was made in response to a preliminary determination letter, during which the Service has failed to respond to the request for an Appeals conference.

SECTION 5. EXAMPLES

The following examples illustrate the exhaustion of administrative remedies requirement, but do not address any other possible jurisdictional defects.

.01 *Example 1*: The executor timely files a Form 706 and makes an election under section 6166(a)(1). The Service issues a preliminary determination letter, tentatively granting the election. The Service subsequently conducts an examination of the estate's Form 706, determines that the estate is not entitled to pay the tax in installments pursuant to section 6166, and sends a second preliminary determination letter to the executor denying the election. The applicant, within 30 calendar days after the mailing date of the second preliminary determination letter, submits a written request for an Appeals conference. The applicant provides all materials requested by Appeals in a timely fashion. Appeals denies the election and sends the applicant a final determination letter. Upon the issuance of the final determination letter, the applicant has exhausted all available administrative remedies within the Service.

.02 *Example 2*: The executor timely files a Form 706, makes elections under section 6166(a) and section 6166(b)(8), and tenders with the return the first installment payment of the tax. The executor receives evidence of the Service's receipt of the Form 706 (*i.e.*, a date-stamped receipt from hand-carrying the return in accordance with Treas. Reg. §§ 20.6091–1 or 20.6091–2, a return receipt from certified or registered mail, a certification by a private delivery service of receipt of a signature upon delivery to the Service, or a written or other subsequent acknowledgment of receipt from the Service). The applicant does not receive any correspondence from the Service relating to the request for a determination. On the 181st calendar day after the filing of the Form 706, the applicant files a petition with the Tax Court requesting a declaratory judgment pursuant to section 7479. Due to the failure of the Service to make a determination regarding the section 6166 election within 180 calendar days after the filing of the Form 706, the applicant is deemed to have exhausted all available administrative remedies within the Service.

.03 *Example 3*: The executor timely files a Form 706 and makes an election under section 6166(a). After an examination of the Form 706, the Service issues a final determination letter recognizing the validity of the election. Subsequently, the Service determines that more than 50 percent of the interest in the closely held business has been disposed of during the deferral period. Pursuant to section 6166(g), the Service issues a preliminary determination letter proposing to terminate the section 6166 election. Within 30 calendar days after the mailing date of the preliminary determination letter, the applicant submits a written request for an Appeals conference. The applicant timely provides all requested information to Appeals. After considering the information provided, Appeals issues a final determination letter that the extension previously granted has ceased to apply. The applicant has exhausted all available administrative remedies within the Service.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for all section 6166 elections filed on or after May 20, 2005. For any section 6166 election filed before May 20, 2005, an applicant may rely on section 4 of this revenue procedure to demonstrate that applicant has exhausted all administrative remedies within the Service.

DRAFTING INFORMATION

The principal author of this revenue procedure is Tracey B. Leibowitz of the Office of the Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). For further information regarding this revenue procedure, contact Ms. Leibowitz at (202) 622–4940 (not a toll-free call).

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26 CFR 601.104: Collection functions.
(Also Part I, §§ 6672; 301.6672.)

Rev. Proc. 2005–34

SECTION 1. PURPOSE

This revenue procedure sets forth updated procedures for appeals of proposed trust fund recovery penalty assessments arising under section 6672 of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 Section 6672(a) imposes a penalty against any person required to collect, truthfully account for, and pay over any tax imposed by the Code who willfully fails to collect, or truthfully account for and pay over the tax, or who willfully attempts in any manner to evade or defeat the tax.

.02 Under section 6671(b), the term "person" includes an officer or employee of a corporation or a member or employee of a partnership, who, as an officer, employee, or member of the corporation or partnership, is under a duty to perform the act in respect of which the violation occurs.

.03 Section 6672(b), as amended by the Taxpayer Bill of Rights 2, Pub. L. No. 104–168, 110 Stat. 1465 (TBOR 2), provides that the Internal Revenue Service is required to send a notice of proposed assessment to any taxpayer against whom it intends to assess a trust fund recovery penalty. In this context, section 6672(b) uses the broader term "taxpayer" because the notice of proposed assessment must be sent to taxpayers who may not ultimately fit within the definition of "person" as set forth in section 6671(b) and as used in sections 6672(a), (c), (d) and (e).

.04 Rev. Proc. 84–78, 1984–2 C.B. 754, which sets forth procedures for appeal of the trust fund recovery penalty, does not reflect the amendments made to section 6672 by TBOR 2.

SECTION 3. SCOPE

The procedures in this revenue procedure apply to trust fund recovery penalty cases relating to employment and excise taxes imposed under the Internal Revenue Code, except when collection is in jeopardy.

See section 6672(c) for procedures relating to a stay of collection if a bond is furnished. See section 6672(d) for provisions regarding the right to contribution if more than one person is liable for the trust fund recovery penalty. See section 6672(e) for rules regarding the exception for voluntary board members of tax-exempt organizations.

SECTION 4. PROCEDURE IN AREA COLLECTION DIVISIONS

.01 If the Service determines that a taxpayer is liable for the trust fund recovery penalty, the Service will propose the assessment of the penalty and inform the taxpayer of the determination by notice. The notice of proposed assessment will provide the taxpayer an opportunity to sign a form agreeing to the proposed assessment or to dispute the proposed assessment by appealing the proposed assessment within 60 days of the date on the notice (75 days if the notice is addressed to the taxpayer outside of the United States) and requesting an Appeals conference.

.02 The Service will assess the penalty if the taxpayer fails to appeal the proposed assessment within the period specified in Section 4.01 of this revenue procedure and the Service has not received a signed agreement from the taxpayer agreeing to the assessment. If the taxpayer submits a timely appeal in response to the notice of proposed assessment and requests that the case be referred to Appeals, the case will be reviewed in the appropriate compliance office to determine whether further action or development is required before referring the case to Appeals.

SECTION 5. PROCEDURE FOR APPEALING A PROPOSED ASSESSMENT AND REQUESTING AN APPEALS CONFERENCE

.01 *Small Case Appeals*. If the proposed penalty assessment for any tax period is $25,000 or less, the taxpayer may appeal the proposed assessment by completing and submitting in writing two copies of a small case appeal request. The request should be mailed to the attention of the IRS officer or employee named on the notice of proposed assessment as the "Person to Contact" at the address shown on the front of the notice. The request must include the following:

(1) A copy of the notice of proposed assessment or the date and number of the notice and the taxpayer's name and social security number, along with any information that will help the Service locate the taxpayer's file;

(2) A statement that the taxpayer is requesting an Appeals conference; and

(3) A list of the issues that the taxpayer is contesting and an explanation of the basis for the taxpayer's disagreement. The explanation should include the following:

(a) The taxpayer's duties and responsibilities during the tax periods listed in the notice of proposed assessment. In particular, the taxpayer should describe whether the taxpayer had the duty and authority to collect, account for, and pay over trust fund taxes; and

(b) If the taxpayer contests the Service's calculation of the penalty, the taxpayer should identify the dates and amounts of payments that the taxpayer believes the Service failed to consider and/or any computational errors made by the Service.

.02 *Large Case Appeals*. If the proposed penalty for any tax period is more than $25,000, the taxpayer may appeal the proposed assessment by submitting a formal written protest. In addition to the items required by section 5.01(1) and (2) of this revenue procedure, the formal written protest must include the following:

(1) The tax period(s) involved;

(2) A list of the findings the taxpayer is contesting;

(3) A statement of facts that describes the following:

(a) The basis for the taxpayer's disagreement with the proposed assessment, including specific facts that support the taxpayer's arguments;

(b) The taxpayer's duties and responsibilities during the tax periods listed in the notice of proposed assessment. In particular, the taxpayer should describe whether the taxpayer had the duty and authority to collect, account for, and pay trust fund taxes; and

(c) If the taxpayer contests the Service's calculation of the penalty, the dates and amounts of payments that the taxpayer believes the Service failed to consider and/or any computational errors made by the Service;

(4) An explanation of any law or other supporting authorities on which the taxpayer relies; and

(5) The following signed declaration under penalties of perjury that the statement of facts required by section 5.02(3) is true:

"Under penalties of perjury, I declare that I have examined the facts presented in this statement and any accompanying information, and to the best of my knowl-

edge and belief, they are true, correct, and complete."

.03 A taxpayer may contest all of the periods listed in the notice in a single protest; however, if the proposed penalty for any one of the periods is more than $25,000, the taxpayer must submit a formal written protest described in section 5.02.

SECTION 6. REPRESENTATION AT CONFERENCE

A taxpayer may represent himself at an Appeals conference or be represented by someone who is authorized to represent taxpayers under Treasury Circular 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service (31 C.F.R. Part 10). If an authorized representative attends an Appeals conference without the taxpayer, the representative must have filed a power of attorney, *see* 26 C.F.R. §§ 601.501 through 601.509, which also will authorize the representative to receive or inspect confidential tax information. If a representative prepares and signs a request for appeal or a written protest on behalf of the taxpayer, the representative must submit a declaration stating whether he or she knows personally that the facts stated in the protest and accompanying documents are true and correct.

SECTION 7. EXTENSION OF THE PERIOD OF LIMITATIONS FOR ASSESSMENT

If the notice of proposed assessment is mailed or delivered before the period for assessing the trust fund recovery penalty ends, the assessment period will not end before the later of:

(1) The date that is 90 days after the Service mailed or delivered the notice of proposed assessment; or

(2) If the taxpayer has filed a timely appeal in response to the notice of proposed assessment, the date that is 30 days after the Secretary makes a final determination regarding the appeal.

SECTION 8. PROCEDURE IN AREA DIRECTOR'S OFFICE FOR DISPOSING OF CLAIMS

.01 If the Service has assessed the trust fund recovery penalty because of the failure of the taxpayer to respond to the notice of proposed assessment within the 60-day period (or 75-day period, if applicable) or on the basis of the decision of Appeals, the taxpayer generally must pay the appropriate portion of the penalty and file a claim for refund in order to pursue judicial review.

.02 Once an assessment has been made, the Service generally will not consider any claim for abatement unless the taxpayer establishes to the compliance area director's satisfaction that unusual circumstances merit consideration of such a claim. If the compliance area director decides not to consider a taxpayer's abatement claim, the taxpayer will be notified of that decision.

.03 Only Appeals may consider a claim for abatement if the assessment was made on the basis of a decision of Appeals. If the assessment was made based on a decision of Appeals, the area director will forward the claim to Appeals for consideration. The taxpayer will be notified if Appeals decides not to consider a taxpayer's abatement claim.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 84–78 is superceded.

SECTION 10. EFFECTIVE DATE

This revenue procedure is effective for all trust fund recovery penalties proposed on or after May 20, 2005.

DRAFTING INFORMATION

The principal author of this revenue procedure is Kevin Connelly of the Office of the Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue procedure, contact Mr. Connelly at (202) 622–3630 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Safe Harbor for Valuation Under Section 475

REG–100420–03

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document sets forth an elective safe harbor for dealers in securities, dealers in commodities, and traders in securities and commodities that permits these taxpayers to make an election pursuant to which the values of positions reported on certain financial statements are the fair market values of those positions for purposes of section 475 of the Internal Revenue Code. This safe harbor attempts to reduce the compliance burden upon taxpayers and to improve the administrability of the valuation aspect of section 475 for the Internal Revenue Service. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 22, 2005. Outlines of topics to be discussed at the public hearing scheduled for September 15, 2005 at 10 a.m. must be received by August 23, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–100420–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–100420–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue N.W., Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS-REG–100420–03).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments, the hearing or to be placed on the building access list to attend the hearing, Treena Garrett at (202) 622–7180; concerning the proposals, Marsha A. Sabin or John W. Rogers III (202) 622–3950 (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 of the Department of Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, D.C. 20224. Comments on the collection of information should be received by July 25, 2005. Comments are specifically requested concerning:

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

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

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

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

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

The collection of information in these proposed regulations is in §1.475(a)–4(f)(1) and §1.475(a)–4(k). This information is required by the IRS to avoid any uncertainty about whether a taxpayer has made an election and to verify compliance with section 475 and the safe harbor method of accounting described in §1.475(a)–4(d). This information will be used to facilitate audits and to determine whether the amount of tax has been calculated correctly. The collection of the information is required to properly determine the amount of income or deduction to be taken into account. The respondents are sophisticated dealers or traders in securities or commodities.

Estimated total annual recordkeeping burden: 49,232 hours.

Estimated average annual burden per recordkeeper: 4 to 6 hours.

Estimated number of recordkeepers: 12,308.

Estimated frequency of recordkeeping: annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number 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 be material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to 26 CFR Part 1 under section 475 of the Internal Revenue Code (Code). Section 475 was added to the Code by section 13223(a) of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103–66, 107 Stat. 312). Section 475(a) generally provides that the securities held by dealers in securities shall be valued as of the last business day of the year at fair market value. Section 475(g) provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of section 475. The legislative history of section 475 indicates that, under this authority, the Secretary may issue regulations to permit the use of valuation methodologies that reduce the administrative burden of compliance on the taxpayer but clearly reflect

income for federal income tax purposes. On May 5, 2003, the Treasury Department and the IRS published in the **Federal Register** an Advance Notice of Proposed Rulemaking (Safe Harbor for Satisfying Certain Statutory Requirements for Valuation under Section 475 for Certain Securities and Commodities) (REG–100420–03) [68 FR 23632] (the ANPRM); Announcement 2003–35, 2003–1 C.B. 956 (see §601.601(d)(2)). The ANPRM solicited comments on whether a safe harbor approach using values reported on an applicable financial statement for certain securities may be used for purposes of section 475. The ANPRM set forth a possible safe harbor for valuing these securities and asked for comments on various aspects of such a safe harbor.

Explanation of Provisions

Overview

Section 475(a) requires dealers in securities to mark their securities to market. Sections 475(e) and (f) allow dealers in commodities and traders in securities or commodities to elect similar treatment for their securities or commodities. If the security or commodity is inventory, it must be included in inventory at its fair market value, and if it is not inventory and is held at the end of the taxable year, gain or loss is recognized as if the security or commodity had been sold for its fair market value on the last business day of the taxable year.

Although the term "fair market value" has a long-standing and well-established meaning within the tax law, it is sometimes difficult to determine the fair market value of certain securities and commodities, particularly those that have no comparable sales. This has impeded the efficient administration of the mark-to-market system under section 475. Consequently, with a view to improving the administrability of the valuation requirements of section 475, the Treasury Department and the IRS issued the ANPRM, which set forth some principles upon which a safe harbor for valuation could be constructed. Using these principles, and incorporating a number of comments received from the public, these proposed regulations set forth a safe harbor for valuing securities and commodities under section 475.

Safe Harbor

The safe harbor generally permits eligible taxpayers to elect to have the values that are reported for eligible positions on certain financial statements treated as the fair market values reported for those eligible positions for purposes of section 475, if certain conditions are met. The safe harbor is based upon the principle that if the mark-to-market method used for financial reporting is sufficiently consistent with the mark-to-market method required by section 475, then the values used for financial reporting should be acceptable values for purposes of section 475, even if those values are not fair market values under general tax principles. To ensure minimal divergence from fair market value under tax principles, these proposed regulations impose certain restrictions on the financial accounting methods and financial statements that are eligible for the safe harbor and also require certain adjustments to the values of the eligible positions on those financial statements that may be used under the safe harbor.

The safe harbor requires that financial statement values be adjusted to comply with the requirements of section 482 or section 482 principles when applicable. For example, section 482 principles may require the revision of estimates of future cash flows used in valuing certain financial instruments to reflect the appropriate arm's length pricing of inter-branch transactions as of their origination date. In addition, these proposed regulations do not alter the treatment of interest expense. See sections 861 and 882 and regulations thereunder.

Eligible Taxpayers and Eligible Positions

The safe harbor is available to any taxpayer subject to the mark-to-mark regime under section 475, whether the taxpayer is a dealer in securities under section 475(a), a dealer in commodities under section 475(e), or a trader in either securities or commodities under section 475(f). The Commissioner will issue a revenue procedure that lists the types of securities and commodities that are subject to the safe harbor. It is anticipated that the revenue procedure will apply to every security position and every commodity position subject to mark-to-market under section 475. Comments are requested as to whether any types of securities or commodities should be excluded from the safe harbor.

It is important to note, however, that the valuation methodology under the safe harbor applies only for positions that are properly marked under section 475. The safe harbor only addresses valuation and does not expand or contract the scope of application of section 475. For example, if a security is not marked under section 475 because it has been identified as held for investment, then under the safe harbor it may not be marked for federal income tax purposes even though it is properly marked on the financial statement in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). Similarly, if a security is not marked on the applicable financial statement because it is a hedge but section 475(a) applies because the security was not identified as a hedge, then the security must still be marked under section 475.

Eligible Method

To qualify for the safe harbor, a financial accounting method must satisfy certain basic requirements. First, it must mark eligible positions to market through valuations made as of the last business day of each taxable year. Second, it must recognize into income on the income statement any gain or loss from marking eligible positions to market. Third, it must recognize into income on the income statement any gain or loss on disposition of an eligible position as if a year-end mark occurred immediately before the disposition. Fourth, it must arrive at fair value in accordance with U.S. GAAP.

In addition to the basic requirements, the safe harbor also imposes certain limitations that ensure minimal divergence from fair market value. Under the first limitation, which applies only to securities and commodities dealers, except for eligible positions that are traded on a qualified board or exchange (as defined in section 1256(g)(7)), the financial accounting method must not result in values at or near the bid or ask values, even if the use of bid or ask values is permissible in accordance with U.S. GAAP. This limitation is based upon the business model for derivative contracts held by dealers in those derivatives, the model underlying

most of the public comments received in response to the ANPRM.

According to the comments, dealers seek to capture and profit from bid-ask spreads by entering into positions that, in the aggregate, offset each other. The bid-ask spread contains the dealer's profit and compensates the dealer for all risks and expenses. The origination of such a balanced portfolio may, therefore, be seen as creating a synthetic annuity, with a value that is largely immune from market-related changes in the values of the component securities. For these eligible positions, such as interest rate swap contracts, use of bid or ask values approximates realization accounting and, therefore, fails to cause recognition of the present value of the synthetic annuity in the taxable year that the annuity is created. Consequently, the valuation method described in §1.471–4(a)(1) generally fails to satisfy the limitation set forth in paragraph (d)(3)(i) of these proposed regulations.

The Treasury Department and the IRS request comments on whether dealers in commodities and traders in either securities or commodities operate under different business models and on how the rules set forth in these proposed regulations should be modified, if at all, to accommodate those business models.

Under the second limitation, if the method of valuation consists of determining the present value of projected cash flows from an eligible position or positions, then the method must not take into account any cash flows of income or expense that are attributable to a period or time before the valuation date. This limitation ensures that items of income or expense will not be accounted for twice, first through current realization and then again in the mark.

Under the third limitation, no cost or risk is accounted for more than once, either directly or indirectly. For example, a financial accounting method that allows a special adjustment for credit risk generally satisfies this limitation. It would not satisfy this limitation, however, if it computed the present value of projected cash flows using a discount rate that takes into account any amount of credit risk that is also taken into account by the special adjustment. Thus, if a dealer in securities enters into an interest rate swap contract with a counterparty with a AA/aa rating, taking credit enhancement and netting agreements into account, then the dealer cannot take a special adjustment to the value of the contract for all of the risk between a counterparty with a risk-free rating and the actual counterparty if the dealer determines the present value of projected cash flows from the contract using a mid-market swap curve based upon the LIBOR AA rate. The Treasury Department and the IRS understand, however, that there may be degrees of credit quality within an established rating level, such as AA/aa, and that valuation methodologies used currently may reflect these nuances in credit quality. Accordingly, a credit adjustment reflecting these nuances may satisfy this limitation.

Election and Revocation

The election to use the safe harbor is made by filing a statement with the taxpayer's timely filed Federal income tax return for the taxable year for which the election is first effective. The statement must declare that the taxpayer makes the safe harbor election for all of its eligible positions. In addition to any other information that the Commissioner may require, the statement must describe the taxpayer's applicable financial statement for the first taxable year for which the election is effective and must state that the taxpayer agrees to timely provide upon the request of the Commissioner all information, records, and schedules required by the safe harbor. The election continues to be in effect for all subsequent taxable years unless it is revoked.

A taxpayer cannot revoke the election without the consent of the Commissioner. The Commissioner, however, can revoke the election if the taxpayer fails to comply with any of the recordkeeping and production requirements and cannot show reasonable cause for the failure, the taxpayer ceases to use an eligible method, the taxpayer ceases to have an applicable financial statement, as described below, or the taxpayer holds a *de minimis* quantity of eligible positions that are subject to the safe harbor. No revocation is necessary if the taxpayer ceases to qualify as an eligible taxpayer, or section 475 does not otherwise apply, because the safe harbor may only be used to determine values and cannot be used unless section 475 applies. Once revoked by either the Commissioner or the taxpayer, neither the taxpayer nor any of its successors may make the election for any taxable year that begins before the date that is six years after the first day of the earliest taxable year affected by the revocation without the consent of the Commissioner.

Applicable Financial Statements

Not all financial statements qualify under the safe harbor. Consequently, these proposed regulations set forth a system that enables a taxpayer to determine which one of its financial statements, if any, may be used when applying the safe harbor.

Three categories of financial statements qualify under the safe harbor and are set forth in order of priority, from highest to lowest. In the first and highest category are those financial statements that must be filed with the Securities and Exchange Commission (SEC), such as the 10-K and the Annual Statement to Shareholders. In the second category are those financial statements that must be provided to the Federal government or any of its agencies other than the IRS. In this category are statements filed by foreign-controlled financial institutions engaged in trade or business within the United States who report their mark-to-market results to the Federal Reserve or the Office of the Comptroller of the Currency. In the third category are certified audited financial statements that are provided to creditors to make lending decisions, that are provided to equity holders to evaluate their investment, or that are provided for other substantial non-tax purposes and are reasonably anticipated to be directly relied on for the purposes for which the statements were created. For a financial statement described in any of the three categories above to qualify as an applicable financial statement, it must be prepared in accordance with U.S. GAAP. If a taxpayer has two statements in the same category, each of which would qualify under the safe harbor, then the statement that results in the highest aggregate valuation of eligible positions is the only financial statement that may qualify for the safe harbor.

Statements filed with the SEC provide a high degree of confidence that the values used on those statements reflect reasonable approximations of fair value. Consequently, there are no additional business use requirements for

those statements. For the second category (statements filed with other agencies of the Federal government) and the third category of statements (the other certified audited financial statements), this degree of confidence is ensured by requiring some substantial non-tax use in the taxpayer's business. This determination of use must take into account whether the taxpayer's reliance on the values exposes the taxpayer to material adverse consequences if the values are incorrect. Accordingly, the safe harbor requires that the values for eligible positions contained in these financial statements be used by the taxpayer in most of the significant management functions of all or substantially all of its business. This use includes activities such as senior management review of business-unit profitability, market risk measurement or management, credit risk measurement or management, internal allocation of capital, and compensation of personnel but does not include either tax accounting or reporting the results of operations to other persons. Significance of use is tested by examining all the facts and circumstances in light of the stated purpose of the business use requirement.

The IRS and Treasury understand that some dealers maintain internal books of account, not prepared in accordance with U.S. GAAP, for separate segments of their business and that these internal books of account may include a charge to each operating segment of an internal "cost of carry" calculated in the manner of interest (and the derivatives dealer book may be treated as a separate business segment for that purpose). The purpose of this cost-of-carry charge is to assess profitability or to reflect the cost of capital in maintaining the positions held in that business segment. The amounts so charged do not reduce the fair value of eligible positions on a balance sheet prepared in accordance with U.S. GAAP. The maintenance of these segmented accounts, which may apply an accounting approach that does not qualify as an eligible accounting method, does not prevent some other financial statement prepared in accordance with U.S. GAAP from qualifying as the taxpayer's applicable financial statement.

Record Retention and Production; Use of Different Values

The safe harbor can be administrable only if the IRS can readily verify that the values used on financial statements are also appropriately used on the Federal income tax return. Consequently, recordkeeping and record production are critical to the safe harbor. These proposed regulations provide specific requirements for the types of records that must be maintained and provided to enable ready verification. In general, electing taxpayers must clearly show: (1) that the same value used for financial reporting was used on the Federal income tax return; (2) that no eligible position subject to section 475 is excluded from the application of the safe harbor; and (3) that only eligible positions subject to section 475 are carried over to the Federal income tax return under the safe harbor. These proposed regulations outline what records must be retained and produced, including certain forms and schedules filed with the Federal income tax return, such as the Schedule M–1, "*Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More*," Schedule M–3, "*Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More*," and Form 1120F, "*U.S. Income Tax Return of a Foreign Corporation*." These proposed regulations also provide that the Commissioner may enter into an advance agreement with a taxpayer on how records are to be maintained and how long the records are to be retained. All of the necessary records must be retained as long as their contents may become material in the administration of any internal revenue law.

To encourage rapid examinations of the Federal income tax returns of electing taxpayers, these proposed regulations require that all necessary records be produced within 30 days after the Commissioner requests them. If the required records are not provided as required, the regulations permit the Commissioner to use his discretion to: (1) extend the 30-day period; (2) excuse minor or inadvertent failures to provide the requested records; (3) require use of values that clearly reflect income but which are different from those used on the applicable financial statement; or (4) revoke the election (as described under "Election and Revocation" above) if a taxpayer does not demonstrate reasonable cause for the failure to maintain and produce the required records.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that it is anticipated that the safe harbor will be used primarily by dealers in securities that are financial institutions with a sophisticated understanding of the capital markets. Because section 475 is elective for traders in securities or commodities or dealers in commodities, some small businesses could qualify for the safe harbor if they make two voluntary elections: (1) an election to mark to market securities or commodities under section 475 and (2) an election to apply the safe harbor. Because both elections are voluntary, it is unlikely any small business taxpayer who thinks the reporting and recordkeeping requirements are too burdensome will make these elections. Furthermore, the total average estimated burden per taxpayer is small, as reported earlier in the preamble. This is because most of the recordkeeping requirements do not require taxpayers to generate new records, but instead require records used for financial reporting purposes to be kept for tax reporting purposes. For all of these reasons, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department specifically request com-

ments on the clarity of these proposed regulations and how they may be made easier to understand. All comments will be available for inspection and copying.

A public hearing has been scheduled for September 15, 2005, beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restriction, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see "FOR FURTHER INFORMATION CONTACT" section of this preamble.

Drafting Information

The principal authors of these proposed regulations are Marsha A. Sabin and John W. Rogers III, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.475(a)–4 also issued under 26 U.S.C. 475(g). * * *

Par. 2. Section 1.475–0 is amended by:

1. Revising the introductory text.

2. Adding entries to the table for §1.475(a)–4.

The revision and addition reads as follows:

§1.475–0 Table of contents.

This section lists the major captions in §§1.475(a)–3, 1.475(a)–4, 1.475(b)–1, 1.475(b)–2, 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1 and 1.475(e)–1.

* * * * *

§1.475(a)–4 Safe harbor for valuation under section 475.

(a) Overview.
(1) Purpose.
(2) Summary of paragraphs.
(b) Safe harbor.
(1) General rule.
(2) Scope of the safe harbor.
(c) Eligible taxpayer.
(d) Eligible method.
(1) Sufficient consistency.
(2) General requirements.
(i) Frequency.
(ii) Recognition at the mark.
(iii) Recognition on disposition.
(iv) Fair value standard.
(3) Limitations.
(i) Bid-ask method.
(ii) Valuations based on present values of projected cash flows.
(iii) Accounting for costs and risks.
(4) Examples.
(e) Compliance with other rules.
(f) Election.
(1) Making the election.
(2) Duration of the election.
(3) Revocation.
(i) By the taxpayer.
(ii) By the Commissioner.
(4) Re-election.
(g) Eligible positions.
(h) Applicable financial statement.
(1) Definition.
(2) Primary financial statement.
(i) Statement required to be filed with Securities and Exchange Commission.
(ii) Statement filed with a Federal agency other than the IRS.
(iii) Certified audited financial statement.
(3) Example.
(4) Financial statements of equal priority.
(5) Consolidated groups.
(6) Supplement or amendment to a financial statement.
(7) Certified audited financial statement.
(i) [Reserved.]
(j) Significant business use.
(1) In general.
(2) Financial statement value.
(3) Management of a business as a dealer or trader.
(4) Significant use.
(k) Retention and production of records.
(1) In general.
(2) Specific requirements.
(i) Reconciliation.
(A) In general.
(B) Values on books and records with supporting schedules.
(C) Consolidation schedules.
(ii) Instructions provided by the Commissioner.
(3) Time for producing records.
(4) Retention period for records.
(5) Agreements with the Commissioner.
(l) [Reserved.]
(m) Use of different values.

* * * * *

Par. 3. Section 1.475(a)–4 is added to read as follows:

§1.475(a)–4 Safe harbor for valuation under section 475.

(a) *Overview*—(1) *Purpose*. This section sets forth a safe harbor that under certain circumstances permits taxpayers to make an election pursuant to which the values of positions reported on certain financial statements are the fair market values of those positions for purposes of section 475. This safe harbor is based on the principle that, if a mark-to-market method used for financial reporting is sufficiently consistent with the requirements of section 475 and if the financial statement employing that method has certain *indicia* of reliability, then the values used on that financial statement should be appropriate values for purposes of section 475. If other provisions of the Code or regulations require adjustments to fair market value, use of the safe harbor does not obviate the need for those adjustments. See paragraph (e) of this section.

(2) *Summary of paragraphs*. Paragraph (b) of this section sets forth the safe harbor. To determine who may use the safe harbor, paragraph (c) of this section defines the term "eligible taxpayer" for purposes of the safe harbor. Paragraph (d) of this section sets forth the basic requirements for determining whether the method used for financial reporting is sufficiently consistent with the requirements of section 475.

Paragraph (e) of this section describes adjustments to the financial statement values that may be required for purposes of applying section 475. Paragraph (f) of this section describes how to make the safe harbor election and the conditions under which the election may be revoked. Paragraph (g) of this section provides that the Commissioner will issue a revenue procedure that lists the types of securities and commodities that may qualify as "eligible positions" for purposes of the safe harbor. Using rules for determining priorities among financial statements, paragraph (h) of this section defines the term "applicable financial statement" and so describes the financial statement, if any, whose values may be used in the safe harbor. In some cases, as required by paragraph (j) of this section, the safe harbor is available only if the taxpayer's operations make significant business use of financial statement values. Paragraph (k) of this section sets forth requirements for record retention and record production. Paragraph (m) of this section provides that the Commissioner may use fair market values that clearly reflect income, but which differ from values used on the applicable financial statement, if a taxpayer fails to comply with the recordkeeping and record production requirements of paragraph (k) of this section.

(b) *Safe harbor*—(1) *General rule*. Subject to any adjustment required by paragraph (e) of this section, if an eligible taxpayer uses an eligible method for the valuation of an eligible position on its applicable financial statement and the eligible taxpayer is subject to the election described in paragraph (f) of this section, the value that the eligible taxpayer assigns to that eligible position in its applicable financial statement is the fair market value of the eligible position for purposes of section 475, even if that value is not the fair market value of the position for any other purpose of the internal revenue laws. Notwithstanding the rule set forth in this paragraph, the Commissioner may, in certain circumstances, use fair market values that clearly reflect income but which are different than the values used on the applicable financial statement. See paragraph (m) of this section.

(2) *Scope of the safe harbor*. The safe harbor may be used only to determine values for eligible positions that are properly marked to market under section 475. It does not determine whether any positions may or may not be subject to mark-to-market accounting under section 475.

(c) *Eligible taxpayer*. An eligible taxpayer is a dealer in securities as defined in section 475(c)(1) and §1.475(c)–1, a dealer in commodities as defined in section 475(e), or a trader in securities or commodities as defined in section 475(f).

(d) *Eligible Method*—(1) *Sufficient consistency*. An eligible method is a mark-to-market method that is sufficiently consistent with the requirements of a mark-to-market method under section 475. To be sufficiently consistent, the eligible method must satisfy all of the requirements of paragraph (d)(2) and paragraph (d)(3) of this section.

(2) *General requirements*. The method—

(i) *Frequency*. Must require a valuation of the eligible position no less frequently than annually, including a valuation as of the last business day of the taxable year;

(ii) *Recognition at the mark*. Must recognize into income on the income statement for each taxable year mark-to-market gain or loss based upon the valuation or valuations described in paragraph (d)(2)(i) of this section;

(iii) *Recognition on disposition*. Must require, on disposition of the eligible position, recognition into income (on the income statement for the taxable year of disposition) as if a year-end mark occurred immediately before such disposition; and

(iv) *Fair value standard*. Must require use of a valuation standard that arrives at fair value in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP) as established by the Financial Accounting Standards Board.

(3) *Limitations*—(i) *Bid-ask method*. Except for eligible positions that are traded on a qualified board or exchange, as defined in section 1256(g)(7), the valuation standard used for the applicable financial statement of an eligible taxpayer must not permit values at or near the bid or ask value. Consequently, the valuation method described in §1.471–4(a)(1) generally fails to satisfy this paragraph (d)(3)(i). The restriction in this paragraph (d)(3)(i) is satisfied if a resulting value is closer to the mid-market value than it is to the bid or ask value.

(ii) *Valuations based on present values of projected cash flows*. If the method of valuation consists of projecting cash flows from an eligible position or positions and determining the present value of those cash flows, the method must not take into account any cash flows (income or expense) attributable to a period or time prior to the valuation date. In addition, adjustment of the gain or loss recognized on the mark may be required with respect to payments on notional principal contracts that will occur after the valuation date to the extent that portions of the payments have been recognized for tax purposes prior to the valuation date and appropriate adjustment has not been made for purposes of determining financial statement value.

(iii) *Accounting for costs and risks*—(A) *General rule*. In a determination of fair value, appropriate costs and risks may be taken into account, but no cost or risk may be accounted for more than once, either directly or indirectly. If appropriate, the costs and risks that may be accounted for, include, but are not limited to, credit risk (appropriately adjusted for any credit enhancement), future administrative costs, and model risk. In the case of credit risk, an adjustment is implicit in computing the present value of cash flows using a discount rate greater than a risk-free rate. Accordingly, a determination of whether any further downward adjustment to value for credit risk is warranted, or whether an upward adjustment is required, must take that implicit adjustment into consideration.

(4) *Examples*. The following examples illustrate this paragraph (d).

Example 1. (i) A, a calendar year taxpayer, is a dealer in securities within the meaning of section 475(c)(1). A generally maintains a balanced portfolio of interest rate swaps and other interest rate derivatives, capturing bid-ask spreads and keeping its market exposure within desired limits (using, if necessary, additional derivatives for this purpose). A uses a mark-to-market method on a statement that it is required to file with the United States Securities and Exchange Commission (Securities and Exchange Commission or SEC) and that satisfies paragraph (d)(2) of this section with respect to both the contracts with customers and the additional derivatives. None of the derivatives is traded on a qualified board or exchange, as defined in section 1256(g)(7). When determining the amount of any gain or loss realized on a sale, exchange, or termination of a position, A makes a proper adjustment for amounts taken into account respecting payments or receipts. All of A's counterparties on the derivatives have credit quality ratings of AA/aa, according to standard credit ratings obtained from private credit rating agencies.

(ii) Under A's valuation method, as of each valuation date A determines a mid-market probability dis-

tribution of future cash flows under the derivatives and computes the present values of these cash flows. In computing these present values, A uses an industry standard yield curve that is appropriate for obligations by persons with credit quality ratings of AA/aa. In addition, based on information including its own knowledge about the counterparties, A adjusts some of these present values either upward or downward to reflect A's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from AA/aa.

(iii) A's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

Example 2. (i) The facts are the same as in *Example 1*, except that A uses risk-free rates to discount the payments to be received under the derivatives. Based on information, including its own knowledge about the counterparties, A adjusts these present values to reflect A's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from a risk-free obligation.

(ii) A's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

Example 3. (i) The facts are the same as in *Example 1*, except that, after computing present values using the discount rates that are appropriate for obligors with credit quality ratings of AA/aa, A, based on information including its own knowledge about the counterparties, adjusts some of these present values either upward or downward to reflect A's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from AAA/aaa.

(ii) A's methodology violates the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once. By using a AA/aa discount rate, A's method takes into account the difference between risk-free obligations and AA/aa obligations. This difference includes the difference between a rating of AAA/aaa and one of AA/aa. By adjusting values for the difference between a rating of AAA/aaa and one of AA/aa, A takes into account risks that it had already accounted for through the discount rates that it used. The same result would occur if A judged some of its counterparties' obligations to be of AAA/aaa quality but A failed to adjust the values of those obligations to reflect the difference between a rating of AAA/aaa and one of AA/aa.

Example 4. (i) The facts are the same as in *Example 1*, except that A determines the mid-market value for each derivative and then subtracts the corresponding part of the bid-ask spread.

(ii) A's methodology violates the rule in paragraph (d)(3)(i) of this section that forbids valuing the derivatives at or near the bid or ask value.

Example 5. (i) The facts are the same as in *Example 1*, and, in addition, A's adjustments for all risks and costs, including credit risk, future administrative costs, and model risk, consistently cause the adjusted value to be at or near the bid value or ask value.

(ii) A's methodology violates the rule in paragraph (d)(3)(i) of this section that forbids valuing the derivatives at or near the bid or ask value.

(e) *Compliance with other rules*. Notwithstanding any other provisions of this section, the fair market values for purposes of the safe harbor must be consistent with section 482 or rules that adopt section 482 principles, when applicable. Thus applicable financial statement values must be adjusted as necessary for purposes of the safe harbor. For example, if a notional principal contract is subject to section 482 or section 482 principles, the values of future cash flows taken into account in determining the value of the contract for purposes of section 475 must be consistent with section 482.

(f) *Election*—(1) *Making the election*. Unless the Commissioner prescribes otherwise, an eligible taxpayer elects under this section by filing with the Commissioner a statement declaring that the taxpayer makes the safe harbor election in this section for all its eligible positions. In addition to any other information that the Commissioner may require, the statement must describe the taxpayer's applicable financial statement for the first taxable year for which the election is effective and must state that the taxpayer agrees to timely provide upon the request of the Commissioner all information, records, and schedules required by paragraph (k) of this section. The statement must be attached to a timely filed Federal income tax return (including extensions) for the taxable year for which the election is first effective.

(2) *Duration of the election*. Once made, the election continues in effect for all subsequent taxable years unless revoked.

(3) *Revocation*—(i) *By the taxpayer*. An eligible taxpayer that is subject to an election under this section may revoke it only with the consent of the Commissioner.

(ii) *By the Commissioner*. The Commissioner, after consideration of all relevant facts and circumstances, may revoke an election under this section, effective beginning with the first open year for which the election is effective or with any subsequent year, if—

(A) The taxpayer fails to comply with paragraph (k) of this section (concerning record retention and production) and the taxpayer does not show reasonable cause for this failure;

(B) The taxpayer ceases to have an applicable financial statement or ceases to use an eligible method; or

(C) For any other reason, no more than a *de minimis* number of eligible positions, or no more than a *de minimis* fraction of the taxpayer's eligible positions, are covered by the safe harbor in paragraph (b) of this section.

(4) *Re-election*. If an election is revoked, either by the Commissioner or by the taxpayer, the taxpayer (or any successor of the taxpayer) may not make the election for any taxable year that begins before the date that is six years after the first day of the earliest taxable year affected by the revocation without the consent of the Commissioner.

(g) *Eligible positions*. Eligible positions mean those types or classes of securities or commodities that are marked to market under section 475 and are described by the Commissioner as eligible positions for purposes of this safe harbor in a revenue procedure or other published guidance.

(h) *Applicable financial statement*—(1) *Definition*. An eligible taxpayer's applicable financial statement for a taxable year is the taxpayer's primary financial statement for that year if the statement is described in paragraph (h)(2)(i) of this section (concerning statements required to be filed with the SEC) or if the statement is both described in either paragraph (h)(2)(ii) or (iii) of this section and also meets the requirements of paragraph (j) of this section (concerning significant business use). Otherwise, or if the taxpayer does not have a primary financial statement for the taxable year, the taxpayer does not have an applicable financial statement for the taxable year.

(2) *Primary financial statement*. For any taxable year, an eligible taxpayer's primary financial statement is the financial statement, if any, described in one or more of paragraphs (h)(2)(i) through (iii) of this section. If more than one financial statement of the taxpayer for the year is so described, the primary financial statement is the one first described in paragraphs (h)(2)(i) through (iii) of this section. A taxpayer has only one primary financial statement for any year.

(i) *Statement required to be filed with the Securities and Exchange Commission*. A financial statement that is prepared in accordance with U.S. GAAP and that is required to be filed with the SEC, such as the 10-K or the Annual Statement to Shareholders.

(ii) *Statement filed with a Federal agency other than the IRS*. A financial statement that is prepared in accordance with U.S. GAAP and that is required to be provided to the Federal government or any of its agencies other than the IRS.

(iii) *Certified audited financial statement*. A certified audited financial statement that is prepared in accordance with U.S. GAAP; that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the eligible taxpayer, or provided for other substantial non-tax purposes; and that the taxpayer reasonably anticipates will be directly relied on for the purposes for which it was created.

(3) *Example*. A prepares a financial statement, FS1, that is required to be filed with a Federal government agency other than the SEC or the IRS, and is thus described in paragraph (h)(2)(ii) of this section. A also prepares a second financial statement, FS2, that is a certified audited financial statement that is given to creditors and that A reasonably anticipates will be relied on for purposes of making lending decisions, and that is thus described in paragraph (h)(2)(iii) of this section. Because FS1, which is described in paragraph (h)(2)(ii) of this section, is described before FS2, which is described in paragraph (h)(2)(iii) of this section, FS1 is A's primary financial statement.

(4) *Financial statements of equal priority*. If two or more financial statements are of equal priority, after applying the rules of paragraph (h)(2) of this section, then the statement that results in the highest aggregate valuation of eligible positions being marked to market under section 475 is the primary financial statement.

(5) *Consolidated groups*. If the taxpayer is a member of an affiliated group that files a consolidated return, the primary financial statement of the taxpayer is the primary financial statement of the common parent (within the meaning of section 1504(a)(1)) of the consolidated group.

(6) *Supplement or amendment to a financial statement*. For purposes of paragraph (b)(1) of this section and this paragraph (h), a financial statement includes any supplement or amendment to the financial statement.

(7) *Certified audited financial statement*. For purposes of this paragraph (h), a financial statement is a certified audited financial statement if it is certified by an independent certified public accountant from a Registered Public Accounting firm, as defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002, Public Law 107–204, 116 Stat. 746 (July 30, 2002), 15 U.S.C. §7201(a)(12), and rules promulgated under that Act, and is—

(i) Certified to be fairly presented (a "clean" opinion);

(ii) Certified to be fairly presented subject to a concern about a contingency, other than a contingency relating to the value of eligible positions (a qualified "subject to" opinion); or

(iii) Certified to be fairly presented except for a method of accounting with which the Certified Public Accountant disagrees and which is not a method used to determine the value of an eligible position held by an eligible taxpayer (a qualified "except for" opinion).

(i) [Reserved].

(j) *Significant business use*—(1) *In general*. A financial statement is described in this paragraph (j) if—

(i) The financial statement contains values for eligible positions;

(ii) The eligible taxpayer makes significant use of financial statement values in most of the significant management functions of its business; and

(iii) That use is related to the management of all or substantially all of the eligible taxpayer's business.

(2) *Financial statement value*. For purposes of this paragraph (j), the term *financial statement value* means—

(i) A value that is taken from the financial statement; or

(ii) A value that is produced by a process that is in all respects identical to the process that produces the values that appear on the financial statement but that is not taken from the statement because either—

(A) The value was determined as of a date for which the financial statement does not value eligible positions; or

(B) The value is used in the management of the business before the financial statement has been prepared.

(3) *Management of a business as a dealer or trader*. For purposes of this paragraph (j), the term *management of a business as a dealer or trader* refers to the financial and commercial oversight of the business. Oversight includes, but is not limited to, senior management review of business-unit profitability, market risk measurement or management, credit risk measurement or management, internal allocation of capital, and compensation of personnel. Management of a business as a dealer or trader does not include either tax accounting or reporting the results of operations to other persons.

(4) *Significant use*. If an eligible taxpayer uses financial statement values for some significant management functions and uses values that are not financial statement values for other significant management functions, then the determination of whether the taxpayer has made significant use of the financial statement values is made on the basis of all the facts and circumstances. This determination must particularly take into account whether the taxpayer's reliance on the financial statement values exposes the taxpayer to material adverse economic consequences if the values are incorrect.

(k) *Retention and production of records*—(1) *In general*. In addition to all records that section 6001 otherwise requires to be retained, an eligible taxpayer subject to the election provided by this section must keep, and timely provide to the Commissioner upon request, records and books of account that are sufficient to establish that the values used for eligible positions for purposes of section 475 are the values used in the applicable financial statement. This obligation extends to all books and records that are required to be maintained for any period for financial or regulatory reporting purposes, even if these books or records may not otherwise be specifically covered by section 6001. All records described in this paragraph (k) must be maintained for the period described in paragraph (k)(4) of this section, even if a lesser period of retention applies for financial statement or regulatory purposes.

(2) *Specific requirements*—(i) *Reconciliation*. Unless the Commissioner otherwise provides—

(A) *In general*. An eligible taxpayer must provide reconciliation schedules between the applicable financial statement for the taxable year and Federal income tax return for that year. The re-

quired reconciliation schedules include all supporting schedules, exhibits, computer programs and any other information used in producing the values and schedules, documentation of rules and procedures governing determination of the values. The required schedules also include a detailed explanation of any adjustments necessitated by imperfect overlap between the eligible positions that the taxpayer marks to market under section 475 and the eligible positions for which the applicable financial statement uses an eligible method. A corporate taxpayer subject to this paragraph (k) must reconcile the net income amount reported on its applicable financial statement to the amount reported on the applicable forms and schedules on its Federal income tax return (such as the Schedule M–1, "*Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More*"; Schedule M–3, "*Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More*"; and Form 1120F, "*U.S. Income Tax Return of a Foreign Corporation*") in the time and manner provided by the Commissioner. Eligible taxpayers that are not otherwise required to file a Schedule M–1 or Schedule M–3 must reconcile net income using substitute schedules similar to Schedule M–1 and Schedule M–3, and these substitute schedules must be attached to the return.

(B) *Values on books and records with supporting schedules*. The books and records must state the value used for each eligible position separately from the value used for any other eligible position. However, an eligible taxpayer may make adjustments to values on a pooled basis, if the taxpayer demonstrates that it can compute gain or loss attributable to the sale or other disposition of an individual eligible position.

(C) *Consolidation schedules*. The taxpayer must provide a schedule showing consolidation and de-consolidation that is used in preparing the applicable financial statement, along with exhibits and subordinate schedules. This schedule must provide information that addresses the differences for consolidation between the applicable financial statement and the Federal income tax return.

(ii) *Instructions provided by the Commissioner*. The Commissioner may provide an alternative time or manner in which an eligible taxpayer subject to this paragraph (k) must establish that the same values used for eligible positions on the applicable financial statement are also the values used for purposes of section 475 on the Federal income tax return.

(3) *Time for producing records*. All documents described in this paragraph (k) must be produced within 30 days of a request by the Commissioner, unless the Commissioner grants a written extension. Generally, the Commissioner will exercise his discretion to excuse a minor or inadvertent failure to provide requested documents if the taxpayer shows reasonable cause for the failure, has made a good faith effort to comply with the requirement to produce records, and promptly remedies the failure. For failures to maintain, or timely produce, records, see paragraph (m) of this section (allowing the Commissioner, but not the taxpayer, to use fair market values which clearly reflect income, but which are different from those values used on the applicable financial statement, for eligible positions that otherwise might be subject to the safe harbor) and paragraph (f)(3)(ii) of this section (allowing the Commissioner to revoke the election).

(4) *Retention period for records*. All materials required by this paragraph (k) and section 6001 must be retained as long as their contents may become material in the administration of any internal revenue law.

(5) *Agreements with the Commissioner*. The Commissioner and an eligible taxpayer may enter into a written agreement that establishes, for purposes of this paragraph (k), which records must be maintained, how they must be maintained, and for how long they must be maintained.

(l) [Reserved].

(m) *Use of different values*. If the taxpayer fails to satisfy paragraph (k) of this section (concerning record retention and record production) with respect to the records that relate to certain eligible positions for a taxable year, the Commissioner may, for those eligible positions for that year, use fair market values under section 475 that are different from those values reported for those positions on the applicable financial statement and are values the Commissioner determines to be appropriate to clearly reflect income. See paragraph (f)(3)(ii) of this section concerning revocation of the election by the Commissioner, when a taxpayer does not produce required records and fails to demonstrate reasonable cause for such failure.

Par. 4. Section 1.475(e)–1 is amended by redesignating paragraphs (d) through (j) as paragraphs (e) through (k), respectively and adding a new paragraph (d) to read as follows:

§1.475(e)–1 Effective dates.

* * * * *

(d) *Effective date*. Section 1.475(a)–4 (concerning a safe harbor to use applicable financial statement values for purposes of section 475) applies to taxable years ending on or after the date on which the Treasury decision promulgating these regulations is published in the **FEDERAL REGISTER**.

* * * * *

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

(Filed by the Office of the Federal Register on May 20, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 24, 2005, 70 F.R. 29663)

Partial Withdrawal of Notice of Proposed Rulemaking, Notice of Proposed Rulemaking, and Notice of Public Hearing

Partnership Equity for Services

REG–105346–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking, notice of proposed rulemaking, and notice of public hearing.

SUMMARY: This document withdraws the remaining portion of the notice of proposed rulemaking published in the **Federal Register** on June 3, 1971 (36 FR 10787) and contains proposed regulations relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services. The proposed regulations provide that the transfer of

a partnership interest in connection with the performance of services is subject to section 83 of the Internal Revenue Code (Code) and provide rules for coordinating section 83 with partnership taxation principles. The proposed regulations also provide that no gain or loss is recognized by a partnership on the transfer or vesting of an interest in the transferring partnership in connection with the performance of services for the transferring partnership. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 22, 2005. Outlines of topics to be discussed at the public hearing scheduled for October 5, 2005, at 10 a.m. must be received by September 14, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–105346–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–105346–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–105346–03).

FOR FURTHER INFORMATION CONTACT: Concerning the section 83 regulations, Stephen Tackney at (202) 622–6030; concerning the subchapter K regulations, Audrey Ellis or Demetri Yatrakis at (202) 622–3060; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Robin Jones, (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 July 25, 2005. Comments are specifically requested concerning:

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

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

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

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

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

The following collections of information in this proposed regulation are in §1.83–3(l):

(1) Requirement that electing partnerships submit an election with the partnership tax return.

(2) Requirement that certain partners submit a document to the partnership;

(3) Requirement that such documents be retained; and

(4) Requirement that partnerships submit a termination document with the partnership tax return as one method of terminating the election.

These collections of information are required by the IRS to determine whether the amount of tax has been calculated correctly. The respondents are partnerships and partners or other service providers.

The estimated total annual reporting and/or recordkeeping burden is 112,500 hours.

The estimated annual burden per respondent/recordkeeper varies from .10 hours to 10 hours, depending on individual circumstances, with an estimated average of 1 hour for partnerships and .25 hour for a partner or service provider. The estimated number of respondents and/or recordkeepers is 100,000 partnerships and 50,000 partners or other service providers.

The estimated annual frequency of responses (used for reporting requirements only) is on occasion.

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

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

Background

Partnerships issue a variety of instruments in connection with the performance of services. These instruments include interests in partnership capital, interests in partnership profits, and options to acquire such interests (collectively, partnership equity). On June 5, 2000, the Treasury Department and the IRS issued Notice 2000–29, 2000–1 C.B. 1241, inviting public comment on the Federal income tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a preferred interest in a partnership for a common interest in that partnership. On January 22, 2003, the Treasury Department and the IRS published in the **Federal Register** (REG–103580–02, 2003–1 C.B. 543 [68 FR 2930]), proposed regulations regarding the Federal income tax consequences of noncompensatory partnership options, convertible equity, and convertible debt. In the preamble to those proposed regulations, the Treasury Department and the IRS requested comments on the proposed amendment to §1.721–1(b)(1) that was published in the **Federal Register** on June 3, 1971 (36 FR 10787), and on the Federal income tax consequences of the issuance of partnership capital interests in connection with the performance of services and options to acquire such interests.

In response to the comments received, the Treasury Department and the IRS are withdrawing the proposed amendment to §1.721–1(b)(1) and issuing these proposed regulations, which prescribe rules on the application of section 83 to partnership interests and the Federal income tax consequences associated with the transfer, vesting, and forfeiture of partnership interests transferred in connection with the performance of services.

Explanation of Provisions

1. Application of Section 83 to Partnership Interests

Section 83 generally applies to a transfer of property by one person to another in connection with the performance of services. The courts have held that a partnership capital interest is property for this purpose. See *Schulman v. Commissioner*, 93 T.C. 623 (1989) (section 83 governs the issuance of an option to acquire a partnership interest as compensation for services provided as an employee); *Kenroy, Inc. v. Commissioner*, T.C. Memo 1984–232. Therefore, the proposed regulations provide that a partnership interest is property within the meaning of section 83, and that the transfer of a partnership interest in connection with the performance of services is subject to section 83.

The proposed regulations apply section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. Although the application of section 83 to partnership profits interests has been the subject of controversy, see, *e.g.*, *Campbell v. Commissioner*, T.C. Memo 1990–162, aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991), n. 7; *St. John v. U.S.*, 84–1 USTC 9158 (C.D. Ill. 1983), the Treasury Department and the IRS do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83. All partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. Moreover, some commentators have suggested that the same tax rules should apply to both partnership profits interests and partnership capital interests. These commentators have suggested that taxpayers may exploit any differences in the tax treatment of partnership profits interests and partnership capital interests. The Treasury Department and the IRS agree with these comments. Therefore, all of the rules in these proposed regulations and the accompanying proposed revenue procedure (described below) apply equally to partnership capital interests and partnership profits interests. However, a right to receive allocations and distributions from a partnership that is described in section 707(a)(2)(A) is not a partnership interest. In section 707(a)(2)(A), Congress directed that such an arrangement should be characterized according to its substance, that is, as a disguised payment of compensation to the service provider. See S. Rep. No. 98–169, 98 Cong. 2d Sess., at 226 (1984).

Section 83(b) allows a person who receives substantially nonvested property in connection with the performance of services to elect to include in gross income the difference between: (A) the fair market value of the property at the time of transfer (determined without regard to a restriction other than a restriction which by its terms will never lapse); and (B) the amount paid for such property. Under section 83(b)(2), the election under section 83(b) must be made within 30 days of the date of the transfer of the property to the service provider.

Consistent with the principles of section 83, the proposed regulations provide that, if a partnership interest is transferred in connection with the performance of services, and if an election under section 83(b) is not made, then the holder of the partnership interest is not treated as a partner until the interest becomes substantially vested. If a section 83(b) election is made with respect to such an interest, the service provider will be treated as a partner for purposes of Subtitle A of the Code. These rules are similar to the current rules pertaining to substantially nonvested stock in a subchapter S corporation. See §1.1361–1(b)(3) (upon an election under section 83(b), the service provider becomes a shareholder for purposes of subchapter S).

These principles differ from Rev. Proc. 2001–43. Under that revenue procedure, if a partnership profits interest is transferred in connection with the performance of services, then the holder of the partnership interest may be treated as a partner even if no section 83(b) election is made, provided that certain conditions are met.

Certain changes to the regulations under both subchapter K and section 83 are needed to coordinate the principles of subchapter K with the principles of section 83. Among the changes that are proposed in these regulations are: (1) conforming the subchapter K rules to the section 83 timing rules; (2) revising the section 704(b) regulations to take into account the fact that allocations with respect to an unvested interest may be forfeited; and (3) providing that a partnership generally recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership. In addition, Rev. Procs. 93–27, 1993–2 C.B. 343, and 2001–43, 2001–2 C.B. 191, which generally provide for nonrecognition by both the partnership and the service provider on the transfer of a profits interest in the partnership for services performed for that partnership, must be modified to be consistent with these proposed regulations. Accordingly, in conjunction with these proposed regulations, the IRS is issuing Notice 2005–43, 2005–24 I.R.B. 1221. That notice contains a proposed revenue procedure that, when finalized, will obsolete Rev. Procs. 93–27 and 2001–43. The Treasury Department and the IRS intend for these proposed regulations and the proposed revenue procedure to become effective at the same time. The proposed amendments to the regulations under section 83 and subchapter K, as well as the notice, are described in further detail below.

The proposed revenue procedure and certain parts of the proposed regulations (as described below) only apply to a transfer by a partnership of an interest in that partnership in connection with the performance of services for that partnership (compensatory partnership interests). The Treasury Department and the IRS request comments on the income tax consequences of transactions involving related persons, such as, for example, the transfer of an interest in a lower-tier partnership in exchange for services provided to the upper-tier partnership.

2. Timing of Partnership's Deduction

Except as otherwise provided in §1.83–6(a)(3), if property is transferred

in connection with the performance of services, then the service recipient's deduction, if any, is allowed only for the taxable year of that person in which or with which ends the taxable year of the service provider in which the amount is included as compensation. See section 83(h). In contrast, under section 706(a) and §1.707–1(c), guaranteed payments described in section 707(c) are included in the partner's income in the partner's taxable year within or with which ends the partnership's taxable year in which the partnership deducted the payments. Under §1.721–1(b)(2) of the current regulations, an interest in partnership capital issued by the partnership as compensation for services rendered to the partnership is treated as a guaranteed payment under section 707(c). Some commentators suggested that the proposed regulations should resolve the potential conflict between the timing rules of section 83 and the timing rules of section 707(c).

Under the proposed regulations, partnership interests issued to partners for services rendered to the partnership are treated as guaranteed payments. Also, the proposed regulations provide that the section 83 timing rules override the timing rules of section 706(a) and §1.707–1(c) to the extent they are inconsistent. Accordingly, if a partnership transfers property to a partner in connection with the performance of services, the timing and the amount of the related income inclusion and deduction is determined by section 83 and the regulations thereunder.

In drafting these regulations, the Treasury Department and the IRS considered alternative approaches for resolving the timing inconsistency between section 83 and section 707(c). One alternative approach considered was to provide that the transfer of property in connection with the performance of services is not treated as a guaranteed payment within the meaning of section 707(c). This approach was not adopted in the proposed regulations due to, among other things, concern that such a characterization of these transfers could have unintended consequences on the application of provisions of the Code outside of subchapter K that refer to guaranteed payments. The Treasury Department and the IRS request comments on alternative approaches for resolving the timing inconsistency between section 83 and section 707(c).

3. Allocation of Partnership's Deduction

The proposed regulations provide guidance regarding the allocation of the partnership's deduction for the transfer of property in connection with the performance of services. Some commentators suggested that the proposed regulations require that the partnership's deduction be allocated among the partners in accordance with their interests in the partnership prior to the transfer.

Section 706(d)(1) provides generally that, if, during any taxable year of a partnership, there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by regulations which takes into account the varying interests of the partners in the partnership during the taxable year. Regulations have not yet been issued describing the rules for taking into account the varying interests of the partners in the partnership during a taxable year. Section 1.706–1(c)(2)(ii) provides that, in the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner's share of partnership items for the taxable year may be determined by either: (1) closing the partnership's books as of the date of the transfer (closing of the books method); or (2) allocating to the departing partner that partner's *pro rata* part of partnership items that the partner would have included in the partner's taxable income had the partner remained a partner until the end of the partnership taxable year (proration method). The Treasury Department and the IRS believe that section 706(d)(1) adequately ensures that partnership deductions that are attributable to the portion of the partnership's taxable year prior to a new partner's entry into the partnership are allocated to the historic partners.

Section 706(d)(2), however, places additional limits on how partnerships may allocate these deductions. Under section 706(d)(2)(B), payments for services by a partnership using the cash receipts and disbursements method of accounting are allocable cash basis items. Under section 706(d)(2)(A), if during any taxable year of a partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item must be determined under the proration method. To allow partnerships to allocate deductions with respect to property transferred in connection with the performance of services under a closing of the books method, the proposed regulations provide that section 706(d)(2)(A) does not apply to such a transfer.

4. Accounting for Compensatory Partnership Interests

A. Transfer of compensatory partnership interest

Under the proposed regulations, the service provider's capital account is increased by the amount the service provider takes into income under section 83 as a result of receiving the interest, plus any amounts paid for the interest. Some commentators suggested that the amount included in the service provider's income under section 83, plus the amount paid for the interest, may differ from the amount of capital that the partnership has agreed to assign to the service provider. These commentators contend that the substantial economic effect safe harbor in the section 704(b) regulations should be amended to allow partnerships to reallocate capital between the historic partners and the service provider to accord with the economic agreement of the parties.

The reallocation of partnership capital in these circumstances is not consistent with the policies underlying the substantial economic effect safe harbor and the capital account maintenance rules. The purpose of the substantial economic effect safe harbor is to ensure that, to the extent that there is an economic benefit or burden associated with a partnership allocation, the partner to whom the allocation is made receives the economic benefit or bears the economic burden. Under section 83, the economic benefit of receiving a partnership interest in connection with the performance of services is the amount that is included in the compensation income of the service provider, plus the amount paid for the interest. This is the amount by

which the service partner's capital account should be increased.

As explained in section 6 below, a proposed revenue procedure issued concurrently with these proposed regulations would allow a partnership, its partners, and the service provider to elect to treat the fair market value of a partnership interest as equal to the liquidation value of that interest. If such an election is made, the capital account of a service provider receiving a partnership interest in connection with the performance of services is increased by the liquidation value of the partnership interest received.

B. Forfeiture of certain compensatory partnership interests

If an election under section 83(b) has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership items that may later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect. Under the proposed regulations, such allocations will be treated as being in accordance with the partners' interests in the partnership if: (a) the partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and (b) all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made are recognized under section 704(b). This safe harbor does not apply if, at the time of the section 83(b) election, there is a plan that a substantially nonvested interest will be forfeited. All of the facts and circumstances (including the tax status of the holder of the substantially nonvested interest) will be considered in determining whether there is a plan that the interest will be forfeited. In such a case, the partners' distributive shares of partnership items shall be determined in accordance with the partners' interests in the partnership under §1.704–1(b)(3).

Generally, forfeiture allocations are allocations to the service provider of partnership gross income and gain or gross deduction and loss (to the extent such items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. These rules are designed to ensure that any partnership income (or loss) that was allocated to the service provider prior to the forfeiture is offset by allocations on the forfeiture of the interest. Also, to carry out the prohibition under section 83(b)(1) on deductions with respect to amounts included in income under section 83(b), these rules generally cause a forfeiting partner to be allocated partnership income to offset any distributions to the partner that reduced the partner's basis in the partnership below the amount included in income under section 83(b).

Forfeiture allocations may be made out of the partnership's items for the entire taxable year. In determining the gross income of the partnership in the taxable year of the forfeiture, the rules of §1.83–6(c) apply. As a result, the partnership generally will have gross income in the taxable year of the forfeiture equal to the amount of the allowable deduction to the service recipient partnership upon the transfer of the interest as a result of the making of the section 83(b) election, regardless of the fair market value of the partnership's assets at the time of forfeiture.

In certain circumstances, the partnership will not have enough income and gain to fully offset prior allocations of loss to the forfeiting service provider. The proposed revenue procedure includes a rule that requires the recapture of losses taken by the service provider prior to the forfeiture of the interest to the extent that those losses are not recaptured through forfeiture allocations of income and gain to the service provider. This rule does not provide the other partners in the partnership with the opportunity to increase their shares of partnership loss (or reduce their shares of partnership income) for the year of the forfeiture by the amount of loss that was previously allocated to the forfeiting service provider.

In other circumstances, the partnership will not have enough deductions and loss to fully offset prior allocations of income to the forfeiting service provider. It appears that, in such a case, section 83(b)(1) may prohibit the service provider from claiming a loss with respect to partnership income that was previously allocated to the service provider. However, a forfeiting partner is entitled to a loss for any basis in a partnership that is attributable to contributions of money or property to the partnership (including amounts paid for the interest) remaining after the forfeiture allocations have been made. See §1.83–2(a).

Comments are requested as to whether the regulations should require or allow partnerships to create notional tax items to make forfeiture allocations where the partnership does not have enough actual tax items to make such allocations. Comments are also requested as to whether section 83(b)(1) should be read to allow a forfeiting service provider to claim a loss with respect to partnership income that was previously allocated to the service provider and not offset by forfeiture allocations of loss and deduction and, if so, whether it is appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the amount of the loss claimed by the service provider. In particular, comments are requested as to whether section 83 or another section of the Code provides authority for such a rule.

5. Valuation of Compensatory Partnership Interests

Commentators requested guidance regarding the valuation of partnership interests transferred in connection with the performance of services. Section 83 generally provides that the recipient of property transferred in connection with the performance of services recognizes income equal to the fair market value of the property, disregarding lapse restrictions. See *Schulman v. Commissioner*, 93 T.C. 623 (1989). However, some authorities have concluded that, under the particular facts and circumstances of the case, a partnership profits interest had only a speculative value or that the fair market value of a partnership interest should be determined by reference to the liquidation value of that interest. See §1.704–1(e)(1)(v); *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991); *St. John v. U.S.*, 1984–1 USTC 9158 (C.D. 111. 1983). But see *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974) (holding under pre-section 83 law that the receipt of a profits interest with a determinable value at the time of receipt resulted in immediate taxation); *Campbell v. Commissioner*, T.C. Memo 1990–162,

aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991).

The Treasury Department and the IRS have determined that, provided certain requirements are satisfied, it is appropriate to allow partnerships and service providers to value partnership interests based on liquidation value. This approach ensures consistency in the treatment of partnership profits interests and partnership capital interests, and accords with other regulations issued under subchapter K, such as the regulations under section 704(b).

In accordance with these proposed regulations, the revenue procedure proposed in Notice 2005–43, 2005–24 I.R.B. 1221, will, when finalized, provide additional rules that partnerships, partners, and persons providing services to the partnership in exchange for interests in that partnership would be required to follow when electing under §1.83–3(l) of these proposed regulations to treat the fair market value of those interests as being equal to the liquidation value of those interests. For this purpose, the liquidation value of a partnership interest is the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of the interest, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated.

6. Application of Section 721 to Partnership on Transfer

There is a dispute among commentators as to whether a partnership should recognize gain or loss on the transfer of a compensatory partnership interest. Some commentators believe that, on the transfer of such an interest, the partnership should be treated as satisfying its compensation obligation with a fractional interest in each asset of the partnership. Under this deemed sale of assets theory, the partnership would recognize gain or loss equal to the excess of the fair market value of each partial asset deemed transferred to the service provider over the partnership's adjusted basis in that partial asset. Other commentators believe that a partnership should not recognize gain or loss on the transfer of a compensatory partnership interest. They argue, among other things, that the transfer of such an interest is not properly treated as a realization event for the partnership because no property owned by the partnership has changed hands. They also argue that taxing a partnership on the transfer of such an interest would result in inappropriate gain acceleration, would be difficult to administer, and would cause economically similar transactions to be taxed differently.

Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. The Treasury Department and the IRS are still analyzing whether an exception to this general rule is appropriate on the transfer of an interest in the capital or profits of a partnership to satisfy certain partnership obligations (such as the obligations to pay interest or rent). However, the Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721 — to defer recognition of gain and loss when persons join together to conduct a business — than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests. Therefore, the proposed regulations provide that partnerships are not taxed on the transfer or substantial vesting of a compensatory partnership interest. Under §1.704–1(b)(4)(i) (reverse section 704(c) principles), the historic partners generally will be required to recognize any income or loss attributable to the partnership's assets as those assets are sold, depreciated, or amortized.

The rule providing for nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in an eligible entity, as defined in §301.7701–3(a) of the Procedure and Administration Regulations, that becomes a partnership under §301.7701–3(f)(2) as a result of the transfer or substantial vesting of the interest. See *McDougal v. Commissioner*, 62 T.C. 720 (1974) (holding that the service recipient recognized gain on the transfer of a one-half interest in appreciated property to the service provider, immediately prior to the contribution by the service recipient and the service provider of their respective interests in the property to a newly formed partnership).

7. Revaluations of Partnership Property

The proposed regulations concerning noncompensatory partnership options published on January 22, 2003, contained special rules regarding the revaluations of partnership property while noncompensatory partnership options were outstanding. Specifically, the regulations proposed modifications to §1.704–1(b)(2)(iv)(*f*) and (*h*) to provide that any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the fair market value, if any, of outstanding options. These proposed regulations do not contain similar provisions, because under recently proposed modifications to the regulations under §1.7041(b)(2)(iv), the obligation to issue a partnership interest in satisfaction of an option agreement is a liability that is taken into account in determining the fair market value of partnership assets as a result of a revaluation. See REG–106736–00, 2003–2 C.B. 60 [68 FR 37434] (June 24, 2003) (relating to the assumption of certain obligations by partnerships from partners).

8. Characterization Rule

The proposed regulations concerning noncompensatory partnership options published on January 22, 2003, contained a rule (§1.761–3) providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. However, the Treasury Department and the IRS have concluded that these proposed regulations should not contain a similar rule for partnership options transferred in connection with the performance of services because of the possibility that constructive transfers of property, subject to section 83, may occur under circumstances other than those described in the proposed rules for treating the holder of a noncompensatory option as a partner. The Treasury Department and the IRS request comments on whether anti-abuse rules are necessary to prevent taxpayers from using the rules in these proposed regulations or the rules in Notice 2005–43 to inappropriately shift items of partnership income or loss between the service provider and the other partners.

9. Retroactive Allocations

Section 761(c) generally allows a partnership to modify its agreement at any time on or prior to the due date for the partnership's return for the taxable year (without regard to extensions). Thus, for example, a partnership could, at the end of its taxable year, amend its partnership agreement to provide that a service provider was entitled to a substantially vested or nonvested interest in partnership profits and losses from the beginning of the partnership's taxable year. It is expected that, if a substantially vested compensatory partnership interest is transferred to an employee or independent contractor (or an election under section 83(b) is made with respect to the transfer of a substantially nonvested compensatory partnership interest to an employee or independent contractor), the partnership will report the transfer on Form W–2, "*Wage and Tax Statement*," or Form 1099–MISC, "*Miscellaneous Income*," as appropriate. The Form W–2 or Form 1099–MISC would be issued to the service provider by the partnership by January 31 of the year following the calendar year in which the partnership interest is transferred, and the partnership would file such forms with the Social Security Administration or IRS, respectively, by February 28 (March 31 if filed electronically) of the year following the calendar year in which the partnership interest is transferred. The service provider would be required to report any income recognized on the transfer of the partnership interest on the service provider's return for the taxable year (of the service provider) in which the transfer occurs.

It is unclear whether the retroactive commencement date of such an interest should be treated as the date of the transfer of the interest for purposes of section 83 and other provisions of the Code outside of subchapter K. If the retroactive effective date of the interest is treated as the transfer date for all purposes, a number of administrative concerns arise. For example, the partnership may not, by the January 31 deadline, have the information necessary to issue Form W–2 or Form 1099–MISC to the service provider. Also, the service provider may not, by the due date for filing the section 83(b) election, have the information necessary to file the election. The Treasury Department and the IRS request comments on the timing for section 83 purposes of retroactive transfers of partnership interests and on any actions that may be appropriate to address the associated administrative concerns.

10. Information Reporting to Partners

As explained above, the proposed regulations treat the transfer of a partnership interest to a partner in connection with the performance of services as a guaranteed payment. To ensure that the service provider partner has the information necessary to include the transfer in income for the taxable year in which the transfer occurs (rather than the taxable year in which or with which ends the partnership taxable year in which the transfer occurs), the Treasury Department and the IRS are considering the possibility of amending the section 6041 regulations to provide that this type of guaranteed payment must be reported by the partnership on Form 1099–MISC, which is required to be issued to the service provider on or before January 31 of the year following the calendar year of such transfer. The Treasury Department and the IRS request comments on whether such a requirement is appropriate and administrable.

Proposed Effective Date

These regulations are proposed to apply to transfers of property on or after the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the reporting burden, as discussed earlier in this preamble, is not expected to be significant. Partnerships with partnership agreements that contain the binding provisions referred to in §1.83–3(l) only will be required to submit a single election form in order to rely on the safe harbor described in that paragraph. Partnerships that desire to elect to use the safe harbor described in §1.83–3(l), but which do not have partnership agreements containing these provisions, are required to obtain partner-level consents to the election. However, these partnerships are expected to be rare. Moreover, in most cases the partners in such partnerships are not expected to be small businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) 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 can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 5, 2005, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight

(8) copies) by September 14, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Audrey Ellis and Demetri Yatrakis of the Office of Associate Chief Counsel (Passthroughs and Special Industries), and Stephen Tackney of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, §1.721–1(b) of the notice of proposed rulemaking that was published in the **Federal Register** on June 3, 1971 (36 FR 10787) is withdrawn.

* * * * *

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 1.83–3 is amended as follows:

1. Paragraph (e) is amended by adding two new sentences after the first sentence.

2. Paragraph (l) is added.

The revision and addition read as follows:

§1.83–3 Meaning and use of certain terms.

* * * * *

(e) *Property*. * * * Accordingly, property includes a partnership interest. The previous sentence is effective for transfers on or after the date final regulations are published in the **Federal Register**. * * *

* * * * *

(l) *Special rules for the transfer of a partnership interest*. (1) Subject to such additional conditions, rules, and procedures that the Commissioner may prescribe in regulations, revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), a partnership and all of its partners may elect a safe harbor under which the fair market value of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest for transfers on or after the date final regulations are published in the **Federal Register** if the following conditions are satisfied:

(i) The partnership must prepare a document, executed by a partner who has responsibility for Federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor apply irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect and attach the document to the tax return for the partnership for the taxable year that includes the effective date of the election.

(ii) Except as provided in paragraph (l)(1)(iii) of this section, the partnership agreement must contain provisions that are legally binding on all of the partners stating that—

(A) The partnership is authorized and directed to elect the safe harbor; and

(B) The partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective.

(iii) If the partnership agreement does not contain the provisions described in paragraph (l)(1)(ii) of this section, or the provisions are not legally binding on all of the partners of the partnership, then each partner in a partnership that transfers a partnership interest in connection with the performance of services must execute a document containing provisions that are legally binding on that partner stating that—

(A) The partnership is authorized and directed to elect the safe harbor; and

(B) The partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective.

(2) The specified effective date of the safe harbor election may not be prior to the date that the safe harbor election is executed. The partnership must retain such records as may be necessary to indicate that an effective election has been made and remains in effect, including a copy of the partnership's election statement under this paragraph (l), and, if applicable, the original of each document submitted to the partnership by a partner under this paragraph (l). If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the election. The safe harbor election also may be terminated by the partnership preparing a document, executed by a partner who has responsibility for Federal income tax reporting by the partnership, which states that the partnership, on behalf of the partnership and each of its partners, is revoking the safe harbor election on the stated effective date, and attaching the document to the tax return for the partnership for the taxable year that includes the effective date of the revocation.

Par. 3. Section 1.83–6 is amended by revising the first sentence of paragraph (b) to read as follows:

§1.83–6 Deduction by employer.

* * * * *

(b) *Recognition of gain or loss*. Except as provided in section 721 and section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. * * *

* * * * *

Par. 4. Section 1.704–1 is amended as follows:

1. In paragraph (b)(0), an entry is added to the table for §1.704–1(b)(4)(xii).

2. In paragraph (b)(1)(ii)(*a*), a sentence is added at the end of the paragraph.

3. Paragraph (b)(2)(iv)(*b*)(*1*) is revised.

4. Paragraph (b)(2)(iv)(*f*)(*5*)(*iii*) is revised.

5. Paragraph (b)(4)(xii) is added.

6. Paragraph (b)(5) *Example 29* is added.

The additions and revisions read as follows:

§1.704–1 Partner's distributive share.

* * * * *

(b) * * *(0) * * *

* * * * *

Substantially nonvested interests......................1.704–1(b)(4)(xii)

* * * * *

(1) * * *

(ii) * * * (*a*) * * * In addition, paragraph (b)(4)(xii) and paragraph (b)(5) *Example 29* of this section apply to compensatory partnership interests (as defined in §1.721–1(b)(3)) that are transferred on or after the date final regulations are published in the **Federal Register**.

* * * * *

(2) * * *

(iv) * * *

(*b*) * * *

(*1*) the amount of money contributed by that partner to the partnership and, in the case of a compensatory partnership interest (as defined in §1.721–1(b)(3)) that is transferred on or after the date final regulations are published in the **Federal Register**, the amount included on or after that date in the partner's compensation income under section 83(a), (b), or (d)(2).

* * * * *

(*f*) * * *

(*5*) * * *

(*iii*) In connection with the transfer or vesting of a compensatory partnership interest (as defined in §1.721–1(b)(3)) that is transferred on or after the date final regulations are published in the **Federal Register**, but only if the transfer or vesting results in the service provider recognizing income under section 83 (or would result in such recognition if the interest had a fair market value other than zero).

* * * * *

(4) * * *

(xii) *Substantially nonvested interests*—(a) *In general*. If a section 83(b) election has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership income, gain, loss, deduction, or credit (or items thereof) that will later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect.

(*b*) *Deemed Compliance with Partners' Interests in the Partnership*. If a section 83(b) election has been made with respect to a substantially nonvested interest, allocations of partnership items while the interest is substantially nonvested will be deemed to be in accordance with the partners' interests in the partnership if—

(*1*) The partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and

(*2*) All material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made are recognized under section 704(b).

(*c*) *Forfeiture allocations*. Forfeiture allocations are allocations to the service provider (consisting of a *pro rata* portion of each item) of gross income and gain or gross deduction and loss (to the extent such items are available) for the taxable year of the forfeiture in a positive or negative amount equal to—

(*1*) The excess (not less than zero) of the—

(*i*) Amount of distributions (including deemed distributions under section 752(b) and the adjusted tax basis of any property so distributed) to the partner with respect to the forfeited partnership interest (to the extent such distributions are not taxable under section 731); over

(*ii*) Amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under section 752(a)) to the partnership with respect to the forfeited partnership interest; minus

(*2*) The cumulative net income (or loss) allocated to the partner with respect to the forfeited partnership interest.

(*d*) *Positive and negative amounts*. For purposes of paragraph (b)(4)(xii)(*c*) of this section, items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts.

(*e*) *Exception*. Paragraph (b)(4)(xii)(*b*) of this section shall not apply to allocations of partnership items made with respect to a substantially nonvested interest for which the holder has made a section 83(b) election if, at the time of the section 83(b) election, there is a plan that the interest will be forfeited. In such a case, the partners' distributive shares of partnership items shall be determined in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. In determining whether there is a plan that the interest will be forfeited, the Commissioner will consider all of the facts and circumstances (including the tax status of the holder of the forfeitable compensatory partnership interest).

(*f*) *Cross references*. Forfeiture allocations may be made out of the partnership's items for the entire taxable year of the forfeiture. See §1.706–3(b) and paragraph (b)(5) *Example 29* of this section.

* * * * *

(5) * * *

Example 29. (i) In Year 1, A and B each contribute cash to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for equal units in LLC. Under LLC's operating agreement, each unit is entitled to participate equally in the profits and losses of LLC. The operating agreement also provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in that partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership. At the beginning of Year 3, SP agrees to perform services for LLC. In connection with the performance of SP's services and a payment of $10 by SP to LLC, LLC transfers a 10% interest in LLC to SP. SP's interest in LLC is substantially nonvested (within the meaning of §1.83–3(b)). At the time of the transfer of the LLC interest to SP, LLC's operating agreement is amended to provide that, if SP's interest is forfeited, then SP is entitled to a return of SP's $10 initial contribution, and SP's distributive share of all partnership items (other than forfeiture allocations under §1.704–1(b)(4)(xii)) will be zero with respect to that interest for the taxable year of the partnership in which the interest was forfeited. The operating agreement is also amended to require that LLC make forfeiture allocations if SP's interest is forfeited. Additionally, the operating agreement is amended to provide that no part of LLC's compensation deduction is allocated to the service provider to whom the interest is transferred. SP makes an election under section 83(b) with respect to SP's interest in LLC. Upon receipt, the fair market value of SP's interest in LLC is $100. In each of Years 3, 4, 5,

and 6, LLC has operating income of $100 (consisting of $200 of gross receipts and $100 of deductible expenses), and makes no distributions. SP forfeits SP's interest in LLC at the beginning of Year 6. At the time of the transfer of the interest to SP, there is no plan that SP will forfeit the interest in LLC.

(ii) Because a section 83(b) election is made, SP recognizes compensation income in the year of the transfer of the LLC interest. Therefore, SP recognizes $90 of compensation income in the year of the transfer of the LLC interest (the excess of the fair market value of SP's interest in LLC, $100, over the amount SP paid for the interest, $10). Under paragraph (b)(2)(iv)(*b*)(*1*) of this section, in Year 3, SP's capital account is initially credited with $100, the amount paid for the interest ($10) plus the amount included in SP's compensation income upon the transfer under section 83(b) ($90). Under §§1.83–6(b) and 1.721–1(b)(2), LLC does not recognize gain on the transfer of the interest to SP. LLC is entitled to a compensation deduction of $90 under section 83(h). Under the terms of the operating agreement, the deduction is allocated equally to A and B.

(iii) As a result of SP's election under section 83(b), SP is treated as a partner starting from the date of the transfer of the LLC interest to SP in Year 3. Section 1.761–1(b). In each of years 3, 4 and 5, SP's distributive share of partnership income is $10 (10% of $100), A's distributive share of partnership income is $45 (45% of $100), and B's distributive share of partnership income is $45 (45% of $100). In accordance with the operating agreement, SP's capital account is increased (to $130) by the end of Year 5 by the amounts allocated to SP, and A's and B's capital accounts are increased by the amounts allocated to A and B. Because LLC satisfies the requirements of paragraph (b)(4)(xii) of this section, LLC's allocations in years 3, 4 and 5 are deemed to be in accordance with the partners' interests in the partnership.

(iv) As a result of the forfeiture of the LLC interest by SP in year 6, LLC is required to recognize income ($90) equal to the amount of the allowable deduction on the transfer of the LLC interest to SP under §1.83–6(c). LLC repays SP's $10 capital contribution to SP, reducing SP's capital account to $120. Under the terms of the operating agreement, because SP forfeited SP's interest, SP's distributive share of all partnership items (other than forfeiture allocations) is zero for Year 6. To reverse SP's prior allocations of LLC income, LLC makes forfeiture allocations of $30 of deductions ($0 (the difference between the $10 distributed to SP and the $10 contributed to LLC by SP) minus $30 (the cumulative net LLC income allocated to SP) to SP in Year 6. Notwithstanding section 706(c) and (d), these allocations may be made out of LLC's partnership items for the entire taxable year of the forfeiture. Thus, in Year 6, $30 of deductions are allocated to SP, and the remaining $220 of net operating income ($200 of gross receipts and $90 of income under §1.83–6(c) less $70 of remaining deductions) are allocated to A and B equally for tax purposes. In accordance with section 83(b)(1) (last sentence), SP does not receive a deduction or capital loss for the amount ($90) that was included in SP's compensation income. Because LLC satisfies the requirements of paragraph (b)(4)(xii) of this section, LLC's allocations in year 6 are deemed to be in accordance with the partners' interests in the partnership.

* * * * *

Par. 5. Section 1.706–3 is added to read as follows.

§1.706–3 Property transferred in connection with the performance of services.

(a) *Allocations of certain deductions under section 83(h)*. The transfer of property subject to section 83 in connection with the performance of services is not an allocable cash basis item within the meaning of section 706(d)(2)(B).

(b) *Forfeiture allocations*. If an election under section 83(b) is made with respect to a partnership interest that is substantially nonvested (within the meaning of §1.83–3(b)), and that interest is later forfeited, the partnership must make forfeiture allocations to reverse prior allocations made with respect to the forfeited interest. See §1.704–1(b)(4)(xii). Although the person forfeiting the interest may not have been a partner for the entire taxable year, forfeiture allocations may be made out of the partnership's items for the entire taxable year.

(c) *Effective date*. This section applies to transfers of property on or after the date final regulations are published in the **Federal Register**.

Par. 6. In §1.707–1, paragraph (c) is amended by revising the second sentence to read as follows:

§1.707–1 Transactions between partner and partnership.

* * * * *

(c) *Guaranteed Payments*. * * * However, except as otherwise provided in section 83 and the regulations thereunder, a partner must include such payments as ordinary income for that partner's taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. * * *

* * * * *

Par. 7. In §1.721–1, paragraph (b) is revised to read as follows.

§1.721–1 Nonrecognition of gain or loss on contribution.

* * * * *

(b)(1) Except as otherwise provided in this section or §1.721–2, section 721 does not apply to the transfer of a partnership interest in connection with the performance of services or in satisfaction of an obligation. The transfer of a partnership interest to a person in connection with the performance of services constitutes a transfer of property to which section 83 and the regulations thereunder apply. To the extent that a partnership interest transferred in connection with the performance of services rendered by a decedent prior to the decedent's death is transferred after the decedent's death to the decedent's successor in interest, the fair market value of such interest is an item of income in respect of a decedent under section 691.

(2) Except as provided in section 83(h) and 1.83–6(c), no gain or loss shall be recognized by a partnership upon—

(i) The transfer or substantial vesting of a compensatory partnership interest; or

(ii) The forfeiture of a compensatory partnership interest. See §1.704–1(b)(4)(xii) for rules regarding forfeiture allocations of partnership items that may be required in the taxable year of a forfeiture.

(3) For purposes of this section, a compensatory partnership interest is an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership (either before or after the formation of the partnership), including an interest that is transferred on the exercise of a compensatory partnership option. A compensatory partnership option is an option to acquire an interest in the issuing partnership that is granted in connection with the performance of services for that partnership (either before or after the formation of the partnership).

(4) To the extent that a partnership interest is—

(i) Transferred to a partner in connection with the performance of services rendered to the partnership, it is a guaranteed payment for services under section 707(c);

(ii) Transferred in connection with the performance of services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under Chapter 1 of the Code.

(5) This paragraph (b) applies to interests that are transferred on or after the date final regulations are published in the **Federal Register**.

* * * * *

Par. 8. Section 1.761–1(b) is amended by adding two sentences to the end of the paragraph to read as follows.

§1.761–1 Terms defined.

* * * * *

(b) * * * If a partnership interest is transferred in connection with the performance of services, and that partnership interest is substantially nonvested (within the meaning of §1.83–3(b)), then the holder of the partnership interest is not treated as a partner solely by reason of holding the interest, unless the holder makes an election with respect to the interest under section 83(b). The previous sentence applies to partnership interests that are transferred on or after the date final regulations are published in the **Federal Register**. * * * * *

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

(Filed by the Office of the Federal Register on May 20, 2005, 8:45 a.m., and published in the issue of the Federal Register for May 24, 2005, 70 F.R. 29675)

Notice of Proposed Rulemaking

Application of Section 367 in Cross Border Section 304 Transactions; Certain Transfers of Stock Involving Foreign Corporations

REG–127740–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the regulations under section 367 relating to certain transfers of stock involving foreign corporations in transactions governed by section 304. Specifically, these proposed regulations provide that if, pursuant to section 304(a)(1), a U.S person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not a transfer to a foreign corporation subject to section 367(a). These proposed regulations also provide that if, pursuant to section 304(a)(1), a foreign acquiring corporation is treated as acquiring the stock of a foreign acquired corporation in a transaction to which section 351(a) applies, such deemed section 351 acquisition is not an acquisition subject to section 367(b).

DATES: Written or electronic comments and requests for a public hearing must be received by August 23, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–127740–04), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–127740–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–127740–04).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Tasheaya L. Warren Ellison, (202) 622–3870; concerning submissions of comments, Sonya Cruse, (202) 622–4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

A. Section 367(a)

A U.S. person's transfer of appreciated property (including stock) to a foreign corporation in connection with any exchange described in sections 332, 351, 354, 356, or 361 generally is treated under section 367(a)(1) as a taxable transaction, unless an exception applies. Congress enacted section 367(a) to prevent the avoidance of U.S. tax on transfers of appreciated property outside the United States in nonrecognition transfers involving foreign corporations. S.R. Rep. No. 169, Vol. 1, 98th Cong. 2d Sess., at 360 (Apr. 2, 1984).

In the case of a U.S. person's transfer of stock to a foreign corporation in an exchange described in section 367(a)(1), §1.367(a)–3 provides exceptions to the general gain recognition rule of section 367(a)(1), if certain conditions are satisfied including, in some instances, the filing of a gain recognition agreement (GRA). *See* §1.367(a)–3(b) (transfer of stock in a foreign corporation) and (c) (transfer of stock in a domestic corporation).

B. Section 367(b)

Section 367(b) addresses transactions covered by sections 332, 351, 354, 355, 356, and 361 in which there is no transfer of property described in section 367(a). Section 367(b) provides that a foreign corporation shall be considered to be a corporation for purposes of these subchapter C provisions, except to the extent provided in regulations. The status of a foreign corporation as a corporation for these purposes may allow various participants to the transaction to qualify for nonrecognition treatment.

One of the underlying policies of section 367(b) is the preservation of the potential application of section 1248. H. R. Rep. No. 94–658, 94th Cong., 1st Sess., at 242 (November 12, 1975). Section 1248 generally recharacterizes gain recognized by a U.S. person (a section 1248 shareholder) that owns 10 percent or more of the total combined voting power of a controlled foreign corporation, as defined in section 957, or, in certain instances, stock of a former controlled foreign corporation, upon the disposition of the stock of such corporation as dividend income to the extent of the earnings and profits that are attributable to such stock (section 1248 amount).

Consequently, §1.367(b)–4(b)(1) generally requires a section 1248 shareholder (or, in certain instances, a foreign corporation that has a section 1248 shareholder) to include in income its section 1248 amount as a result of certain section 367(b) transactions, including certain section 351 exchanges, if as a result of the transaction

section 1248 shareholder status or controlled foreign corporation status is lost.

C. Section 304

Section 304 was enacted to prevent withdrawals of corporate earnings by controlling shareholders in transactions that result in capital gains treatment. See H.R. Rep. No. 2014, 105th Cong. 1st Sess., at 465 (June 24, 1997). Section 304(a)(1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations and in return for property one of the corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the person (or persons) so in control, then such property shall be treated as a distribution in redemption of the acquiring corporation stock.

Prior to 1997, section 304(a)(1) provided that, to the extent of a distribution treated as a distribution to which section 301 applies, the issuing corporation stock would be treated as having been transferred by the person from whom acquired, and as having been received by the acquiring corporation as a contribution to the capital of the acquiring corporation. Section 304 was amended by section 1013 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 918) (August 5, 1997) to provide that, to the extent that a stock acquisition covered by section 304(a)(1) is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation are treated as if (1) the transferor transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation then redeemed the stock it is treated as having issued. Because the acquiring corporation is treated as receiving the stock of the issuing corporation in a transaction to which section 351 applies, the transferor's basis in the stock of the issuing corporation carries over to the acquiring corporation under section 362.

In the case of an acquisition to which section 304(a) applies, section 304(b)(2) generally provides that the determination of the amount that is a dividend (and the source thereof) is made as if the property were distributed first by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits. In a transaction involving a foreign acquiring corporation, section 304(b)(5) may limit the amount of the earnings and profits of the foreign acquiring corporation that will be taken into account for purposes of section 304(b)(2)(A).

D. Application of Section 367 to Section 304(a)(1) Transactions

The application of section 367(a) and (b) to certain section 304(a)(1) transactions involving a foreign corporation has been addressed in various published guidance. *See*, *e.g.*, Rev. Rul. 91–5, 1991–1 C.B. 114 (holding that section 367 applied to the deemed contribution to capital of target corporation stock under prior law because section 367(c)(2) resulted in the stock transfer constituting a section 351 exchange). Moreover, in the preamble to the proposed regulations regarding redemptions taxable as dividends (REG–150313–01, 2002–2 C.B. 777 [67 FR 64331] October 18, 2002), the IRS and Treasury indicated that certain international provisions may apply to section 304(a)(1) transfers, and provided as an example the application of section 367 and the regulations promulgated thereunder to a deemed section 351 exchange involving foreign corporations. The IRS and Treasury also stated that further guidance on the application of the international provisions to section 304(a)(1) transactions would be forthcoming.

The IRS and Treasury have determined that the policies underlying section 304 (prevention of withdrawals of corporate earnings through the use of transactions that result in capital gains treatment), section 367(a) (prevention of U.S. tax avoidance through transfers of appreciated property to foreign corporations), and section 367(b) (*inter alia*, preservation of the potential application of section 1248) are preserved if section 367(a) and (b) are not applied to a deemed section 351 exchange resulting from a section 304(a)(1) transaction. In addition, the IRS and Treasury believe that the interests of sound tax administration are served by not applying section 367(a) and (b) to a deemed section 351 exchange resulting from a section 304(a)(1) transaction. Consequently, these proposed regulations provide that section 367(a) and (b) will not apply to a deemed section 351 exchange resulting from a section 304(a)(1) transaction. These proposed regulations do not address section 351 transactions other than those exchanges treated as section 351 exchanges by reason of section 304(a)(1).

1. Application of section 367(a)

In a section 304(a)(1) transaction in which a U.S. person transfers the stock of an issuing corporation to a foreign acquiring corporation, without the application of section 367(a), the U.S. person will nevertheless recognize an amount of income that is at least equal to the inherent gain in the stock of the issuing corporation that is being transferred to the foreign acquiring corporation. This income recognition results from the construct of the transaction as a distribution in redemption of the acquiring corporation shares. The income recognized may be in the form of dividend income, gain on the disposition of stock, or both. Section 301(c)(1), (3). Thus, the policy underlying section 367(a), which is to prevent the avoidance of U.S. tax on transfers of appreciated property to a foreign corporation in certain nonrecognition transactions, is maintained through the operation of subchapter C principles even if section 367(a) is not applied to a section 304(a)(1) transaction. Moreover, as discussed below, the application of section 367(a) to a section 304(a)(1) transaction may, in certain instances where the U.S. transferor files a GRA, result in a total income inclusion that is greater than the fair market value of the stock being transferred. The IRS and Treasury believe that this result is inconsistent with the policies of section 367.

For instance, in order to avoid recognizing gain on a section 351 transfer of appreciated foreign stock to a foreign corporation under section 367(a)(1), a U.S. person may be required to enter into a GRA. *See* §1.367(a)–3(b)(1)(ii). As noted, when a U.S. person transfers stock of a wholly owned foreign corporation (the foreign issuing corporation) to a wholly owned foreign acquiring corporation in exchange for property, section 304(a)(1) treats the U.S. person as having received foreign acquiring corporation stock in a deemed sec-

tion 351 exchange, and then as having that stock immediately redeemed by the foreign acquiring corporation. If the U.S. person were to enter into a GRA, the application of section 367(a) to such a transaction will likely result in the GRA remaining in existence after the deemed redemption of the foreign acquiring corporation's stock. A U.S. person may, in fact, recognize income but, as a result of the GRA, not recognize any gain in the section 304(a)(1) transaction (*e.g.*, the section 304(a)(1) transaction results in dividend income to the U.S. corporate transferor equal to the consideration paid by the foreign acquiring corporation). In such a case, because the U.S. person has not recognized the inherent gain in the transferee foreign corporation's stock deemed to be received in the section 304(a)(1) transaction, the GRA will not be terminated. See §1.367(a)–8(h)(1) (requiring a transaction in which all realized gain (if any) is recognized currently to terminate a GRA). As a result, the U.S. transferor would remain subject to the GRA provisions contained in §1.367(a)–8. If the GRA subsequently were triggered pursuant to §1.367(a)–8(e) (*e.g.*, if the foreign issuing corporation disposes of substantially all of its assets to an unrelated party during the 5-year GRA period), the U.S. transferor may be subject to a total income inclusion that is greater than the fair market value of the stock being transferred.

The application of section 367(a) to the transaction described above also results in administrative burdens for both the IRS and taxpayers. For instance, the conditions contained in §1.367(a)–3(b) and (c) require a determination of the value and class of stock either received by the U.S. person in the transaction or owned by the U.S. person immediately after the transfer. *See*, *e.g.*, §1.367(a)–3(b)(1)(i) and (ii) and (c)(1)(i), (ii), and (iii). To the extent the transaction is described in section 304(a)(1), the foreign acquiring corporation does not actually issue any stock to the U.S. person. Therefore, in order to apply the above provisions, the IRS and taxpayers must make determinations based on the stock that is deemed to be issued by the foreign acquiring corporation.

For the reasons stated above, the IRS and Treasury have decided to exercise their regulatory authority under section 367(a) such that section 367(a) will not apply to deemed section 351 exchanges resulting from section 304(a)(1) transactions.

2. Application of section 367(b)

As discussed above in the preamble under heading B, §1.367(b)–4(b)(1) provides that, in the case of a section 351 exchange of stock of a foreign acquired corporation by a U.S. person that is a section 1248 shareholder of such corporation (or a controlled foreign corporation that has a section 1248 shareholder) to a foreign acquiring corporation, the section 1248 shareholder (or a controlled foreign corporation that has a section 1248 shareholder) must include in income its section 1248 amount, unless the requisite section 1248 shareholder status or controlled foreign corporation status is maintained immediately after the exchange. However, in a section 304(a)(1) transaction in which section 1248 shareholder status and controlled foreign corporation status is maintained immediately after the deemed section 351 exchange, such that there is no section 1248 inclusion, the transferor may be treated as receiving a dividend from the foreign acquired corporation pursuant to section 304(b)(2)(B). Thus, in a section 304(a)(1) transaction, some or all of the earnings that make up the section 1248 amount that section 367(b) seeks to preserve may be immediately included in income by the exchanging shareholder.

Additionally, application of §1.367(b)–4(b)(1) can, in some instances, create administrative burdens and be problematic. Section 1.367(b)–4(b)(1) requires a determination of the type and amount of stock received in the deemed section 351 exchange to determine whether the necessary section 1248 shareholder status and controlled foreign corporation status is maintained. Moreover, the application of §1.367(b)–4(b)(1) to a section 304(a)(1) transaction often can be problematic because the necessary section 1248 shareholder status and controlled foreign corporation status may be treated as satisfied in the construct of the deemed section 351 exchange even though such status is immediately lost as a result of the deemed redemption transaction. For instance, the necessary section 1248 shareholder status and controlled foreign corporation status may be satisfied immediately after the deemed section 351 exchange when a U.S. corporation transfers a controlled foreign corporation (the foreign issuing corporation) to a foreign acquiring corporation in a section 304(a)(1) transaction, by taking into consideration the deemed issued stock by the foreign acquiring corporation. However, if both the U.S. corporate transferor and the foreign acquiring corporation are wholly owned by the same foreign parent, the necessary section 1248 shareholder status and controlled foreign corporation status will not be satisfied immediately after the deemed redemption transaction.

For the reasons listed above, the IRS and Treasury have decided to exercise their regulatory authority under section 367(b) such that section 367(b) will not apply to deemed section 351 exchanges resulting from section 304(a)(1) transactions.

E. Request for Comments

Section 304(b)(6) grants the Secretary authority to prescribe regulations that are appropriate in order to eliminate multiple inclusions of any item of income by reason of section 304(a) and to provide appropriate basis adjustments (including modifications to the application of sections 959 and 961) in section 304(a) transactions in which the acquiring or issuing corporation is a foreign corporation. The IRS and Treasury are considering whether to issue regulations under section 304(b)(6) to adjust (1) the acquiring corporation's basis of the issuing corporation stock it acquires in the transaction, and (2) the transferor's basis of the issuing corporation stock in situations in which the transferor continues to own issuing corporation stock immediately after the transaction, to the extent that the transferor is treated under section 304(b)(2)(B) as receiving a distribution from the earnings and profits of the issuing corporation. Comments are requested regarding how such adjustments should be made, particularly if different classes of issuing corporation stock are acquired or retained in the section 304(a)(1) transaction. Comments also are requested as to how, and to what extent, these types of adjustments should be made outside the context of section 304(b)(6) (*e.g.*, in a section 304(a)(1) transaction in which both the acquiring corporation and issuing corporation are domestic corporations).

Effective Dates

The proposed regulations are proposed to apply to section 304(a)(1) transactions occurring on or after the date of publication of these regulations as final in the **Federal Register**.

Effect on other Documents

If these proposed regulations are adopted as final regulations, Rev. Rul. 91–5, 1991–1 C.B. 114, and Rev. Rul. 92–86, 1992–2 C.B. 199, will be modified to the extent inconsistent with such final regulations.

Special Analyses

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

Comments and Public Hearing

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

Drafting Information

The principal author of these regulations is Tasheaya L. Warren Ellison, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and 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 1.367(a)–3 is amended as follows:

1. A sentence is added to paragraph (a) immediately following the second sentence.

2. The new fourth sentence of paragraph (a) is amended by removing the language "However" and adding "Additionally" in its place.

3. The first sentence of paragraph (e)(1) is removed and two sentences are added in its place.

The revision and additions read as follows:

§1.367(a)–3 Treatment of transfers of stock or securities to foreign corporations.

(a) *In general*. * * * However, if, pursuant to section 304(a)(1), a U.S. person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not a transfer to a foreign corporation subject to section 367(a). * * *

* * * * *

(e) *Effective dates*. (1) *In general*. The rules in paragraphs (a), (b) and (d) of this section generally apply to transfers occurring on or after July 20, 1998. However, the third sentence of paragraph (a) of this section shall apply to section 304(a)(1) transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**. * * *

* * * * *

Par. 3. In §1.367(b)–4, a sentence is added to the end of paragraph (a) to read as follows:

§1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

(a) *Scope*. * * * However, if pursuant to section 304(a)(1), a foreign acquiring corporation is treated as acquiring the stock of a foreign acquired corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not an acquisition subject to section 367(b).

* * * * *

Par. 4. 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*. Sections 1.367(b)–1 through 1.367(b)–5, and this section, generally apply to section 367(b) exchanges that occur on or after February 23, 2000. However, the last sentence of paragraph (a) in §1.367(b)–4 shall apply to section 304(a)(1) transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

Cono R. Namorato,
Acting Deputy Commissioner for Services and Enforcement.

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Announcement and Report Concerning Pre-Filing Agreements

Announcement 2005–42

Introduction

This Announcement is issued pursuant to the Conference Report to H.R. 4577 (Pub. L. No. 106–554), *The Community Renewal Tax Relief Act of 2000*, which

requires that the Secretary of the Treasury make publicly available an annual report relating to the Pre-Filing Agreement ("PFA") program operations for the preceding calendar year. The Conference Report states that the report is to include: (1) the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to audit, (6) the average length of time required to complete an agreement, (7) the number, if any, and subject of technical advice and Chief Counsel advice memoranda issued to address issues arising in connection with any pre-filing agreement, (8) any model agreements, and (9) any other information the Secretary deems appropriate. This is the fifth annual report. It provides information concerning activity under the permanent PFA program (Rev. Proc. 2001–22, 2001–1 C.B. 745), during calendar year 2004.

Background

The Large and Midsize Business Division (LMSB) of the Internal Revenue Service serves 170,000 of America's largest corporate and partnership entities — businesses with assets of over $10 million. Their tax issues are among the most complex, and their collective annual tax liability approaches $159 billion. The largest of these taxpayers deal with the IRS on a continuous basis.

One of LMSB's strategic initiatives is issue management. Through effective issue management, LMSB seeks to resolve issues of tax controversy on a more current basis. This includes, but is not limited to, increasing the efficiency of the examination process and seeking alternative issue resolution tools. The PFA program was designed to support LMSB's issue management initiative. LMSB believes the PFA program reduces taxpayer burden and makes more effective use of IRS resources by resolving or eliminating controversies before the tax return is filed.

The PFA program is designed to permit a taxpayer to resolve, before the filing of a return, the treatment of an issue that otherwise would likely be disputed in a post-filing examination. The PFA program is intended to produce agreement on factual issues and apply settled legal principles to those agreed-upon facts. A PFA is a specific matter closing agreement under § 7121 of the Internal Revenue Code and resolves the subject of the PFA for a specified taxable period. Execution of a PFA that resolves issues prior to filing permits taxpayers to avoid costs, burdens and delays that are frequently incident to post-filing examination disputes between taxpayers and the IRS.

PFA Program

The IRS established a permanent PFA program with the issuance of Rev. Proc. 2001–22 and revised it on December 22, 2004, with the issuance of Rev. Proc. 2005–12, 2005–2 I.R.B. 311. Although many of the procedures remained the same, there were some significant changes and clarifications:

- PFAs may cover the current and up to four future taxable years;
- PFAs are available to determine the appropriate methodologies for determining tax consequences affecting future years;
- PFAs are for completed transactions only; and
- PFAs with international tax issues require concurrence of the Director, International; certain international issues listed in Rev. Proc. 2005–12 also require concurrence of the Associate Chief Counsel (International) in acceptance and execution.

PFA Process

The PFA process is managed and conducted by LMSB Industry Directors and field staff, with support from the Office of Pre-Filing and Technical Guidance in LMSB Headquarters. The PFA Program Manager receives all applications and, with the assistance of the Technical Advisors and the Office of Chief Counsel, ensures that the issues presented are appropriate for inclusion in the PFA program.

The Industry Director with jurisdiction over the taxpayer makes the final decision whether to accept a taxpayer's request for participation in the PFA program. The criteria for selecting a request include:

a. The suitability of the issue presented by the taxpayer;
b. The direct or indirect impact of a PFA upon other years, issues, taxpayers, or related cases;
c. The availability of IRS resources;
d. The ability and willingness of the taxpayer to dedicate sufficient resources to the process;
e. The likelihood that the PFA may result in contrary positions with respect to an item or transaction ("whipsaw"); and
f. The probability of completing the examination of the issue and entering into a PFA by the target date.

For the cases selected for participation in the PFA program, a mandatory orientation session for the examination team and the taxpayer is conducted. Subsequently, the taxpayer and the examination team convene a joint planning meeting to reach agreement on a proposed timeframe, to identify and arrange for IRS access to relevant records and testimony, and to define the potential scope and nature of the PFA.

The examination team conducts the factual determination and issue development consistent with IRS auditing standards. Based upon an examination of the issue, the Team Manager prepares a PFA recommendation for the Industry Director. The Industry Director's decision to execute a PFA closing agreement is based on the Team Manager's recommendation and discussions with the PFA Program Manager, Chief Counsel attorneys, appropriate Technical Advisors, and the taxpayer. Following Chief Counsel review to ensure that the proposed PFA closing agreement conforms with guidance provided in Rev. Proc. 68–16, 1968–1 C.B. 770 (regarding closing agreements), the Industry Director will execute a PFA if he or she determines that:

a. Entering into the PFA is consistent with the goals of the PFA program as stated in Rev. Proc. 2001–22 (or Rev. Proc 2005–12 for applications received after December 22, 2004);
b. The resolution in the PFA reflects settled legal principles and correctly applies those principles (or positions authorized under Delegation Order Nos. 4–24 or 4–25) to facts found by the examination team; and

c. There appears to be an advantage in having the issue(s) permanently and conclusively closed for the taxable period covered by the PFA, or that the taxpayer shows good and sufficient reasons for desiring a closing agreement and that the United States would sustain no disadvantage through consummation of such an agreement (see § 301.7121–1(a) of the Procedure and Administration Regulations).

Program Oversight

A designated PFA Program Manager assigned to the Office of Pre-Filing and Technical Guidance in LMSB Headquarters provides oversight for the PFA program. The PFA Program Manager provides assistance to taxpayers, Industry Directors, and Team Managers throughout the process.

Pre-Filing Agreement Program Accomplishments

Statistical Overview of PFA Program — Calendar Year 2004

The tables below reflect the status of PFA applications received in calendar year 2004.

PFA Applications Received in Calendar Year 2004	**Totals**
Applications Withdrawn before Acceptance/Rejection in 2004	2
Applications Rejected in 2004	12
Applications in Screening Process on 12–31–04	1
Applications Pending Acceptance/Rejection on 12–31–04	1
Applications Accepted in 2004	22
Total Applications Received in 2004	*38*

Disposition of PFA Applications Accepted in Calendar Year 2004	**Totals**
Applications Withdrawn after Acceptance in 2004	1
Applications for Which There Were Closing Agreements in 2004	8
Applications In Process on 12–31–04	13
Total Applications Accepted in 2004	*22*

Description of Applications Received in Calendar Year 2004

The applications received by the PFA program in calendar year 2004 came from taxpayers in each LMSB industry segment and involved a variety of issues as provided in the tables below.

Number of Applications Received and Accepted by Industry Segment

Industry Segment	*Received*	*Accepted*
Financial Services	12	6
Retailers, Food, Pharmaceuticals & Healthcare	7	4
Natural Resources & Construction	6	5
Communications, Technology & Media	6	3
Heavy Manufacturing & Transportation	7	4
Total	**38**	**22**

Types of Issues Covered

Issue	**Received**	**Accepted**
Donation of Property	4	1
Research and Experimental Credit	9	7
Estimated Basis of the Stock of a Subsidiary	1	1

Type of Merger/Reorganization	1	0
Valuation of Stock of a Target Corporation	1	1
Worthless Securities and Bad Debts	6	4
Income from Intercompany Notes	1	0
Amount and Character of Partnership Investment Losses	1	0
Deductibility of Fines and Penalties	2	2
Deductibility of Interest to Purchase Tax Exempt Securities	1	1
Merger — Tax Free Reorganization	1	0
Tax Free Split-off	1	0
Treatment of Transfer and Sale of Stock	1	1
Cost Segregation Study — Asset Class Life and Recovery Period	2	2
Synthetic Fuel Credit	1	1
Taxability of Transfer of Rights to an LLC	1	0
Apportionment of General and Administrative Expenses	1	1
Characterization of Remuneration as Wages versus Partnership Distribution	1	0
Transfer Pricing — Royalty	1	0
Transfer of Stock under IRC § 83	1	0
Total	**38**	**22**

Reasons Why Applications Received in Calendar Year 2004 Were Not Accepted

Reasons for Non-acceptance	**Applications**
Not Well-Settled Law	5
Not Enough Time to Complete	2
Issue Not Suitable or Ineligible	4
Currently in Litigation with Taxpayer on the Issue	1
Total	**12**

PFA Program Summary (2004 and Prior Calendar Years)

Forty accepted applications (including applications accepted in prior years) were resolved or withdrawn in 2004.

Taxpayer Withdrawals (4)

In accordance with procedures set forth in Rev. Proc. 2001–22, four taxpayers withdrew from the PFA process in 2004 after their requests had been accepted (three of these were accepted before 2004). In one case the taxpayer and the Service agreed that the timeline was too burdensome. In the other cases, no explanation for the withdrawal was given by the taxpayer.

IRS Withdrawal (8)

In 2004, the Service withdrew from the PFA process in eight cases accepted before 2004. In one case, the taxpayer did not have adequate records to substantiate a deduction for the Research and Experimental Credit. In the other seven cases, the taxpayer and the Service were unable to reach agreement.

Mutual Withdrawal (1)

The Service and the taxpayer mutually agreed to terminate the PFA process in one case. They agreed that it would be more efficient to roll the issue into the normal examination process rather than continuing with the PFA process.

PFAs Executed (27)

Twenty seven PFAs were completed in calendar year 2004 that resulted in the execution of closing agreements. Eight of these were for applications received and accepted in 2004.

The Office of Chief Counsel provided advice to the examination teams and assisted in the drafting and review of the PFA closing agreements. No Technical Advice or Chief Counsel Advice Memoranda were issued for issues addressed in the PFA process.

PFAs Executed in 2004

The PFAs executed in 2004 involved the following issues:

PFAs Executed by Issue

Year Application Received	Issue	Number
2002	Deductibility and Fair Market Value of Donated Property	1
2003	Deductibility and Fair Market Value of Donated Property	4
2004	Deductibility and Fair Market Value of Donated Property	1
2003	Amount of Qualified Research and Experimental Credit	4
2004	Amount of Qualified Research and Experimental Credit	2
2003	Fair Market Value of Stock Exchanged	1
2004	Cost Segregation for Asset Class and Recovery Periods	1
2003	Treatment of License Fee Income	1
2004	Deductibility of Fees to Purchase Tax Exempt Securities	1
2002	Gain or Loss on Sale of Stock	1
2002	Worthless Securities and Bad Debts	1
2003	Worthless Securities and Bad Debts	3
2004	Worthless Securities and Bad Debts	2
2002	Fuel Credit	1
2003	Ordinary Versus Capital Loss on Property Sale	1
2003	Writedown of Inventory	1
2004	Deductibility of Fines and Penalties	1
	Total	**27**

Deductibility and Fair Market Value of Donated Property (6)

In each of these unrelated cases, the taxpayer sought an agreement as to the fair market value of property donated to qualified organizations. Patents and technology were donated in four cases and land was donated in two other cases. In three of the cases, a closing agreement was executed specifying the fair market value of the property contributed. In the other three cases, both fair market value and deductibility were addressed, and in one of these, no deduction was allowed.

Amount of Qualified Research and Experimental Credit (6)

The taxpayers requested an agreement regarding the proper amount of qualified research expenses and the research credit under IRC § 41. Closing agreements were executed with all taxpayers. The closing agreements did not address the methodology to be used for subsequent years.

Fair Market Value of Stock Exchanged (1)

The taxpayer requested an agreement concerning the value of preferred stock in transactions intended to qualify as transfers to a controlled corporation under IRC § 351. A closing agreement was executed that specified the fair market value of the transferred stock and provided that the IRS would not challenge the value under IRC § 482 or other Code sections.

Cost Segregation for Asset Class and Recovery Periods (1)

The taxpayer requested an agreement concerning the proper class lives and recovery periods of property placed in service during the tax year. The taxpayer and Service agreed to use statistical sampling techniques and came to agreement on the depreciation deduction amount. A closing agreement was executed specifying the amount allowed.

Treatment of License Fee Income (1)

The taxpayer requested an agreement regarding the treatment of periodic fee income from software licenses. A closing agreement was executed specifying that the licenses shall be treated as leases rather than sales of software and that the fees shall be included in income in the year due and payable.

Deductibility of Fees to Purchase Tax Exempt Securities (1)

The taxpayer requested an agreement regarding the deductibility of periodic interest and other costs on debt. Some of the proceeds of this debt were temporarily invested in tax exempt securities. A closing agreement was executed specifying that the interest and costs are not to be disallowed under IRC § 265.

Gain or Loss on Sale of Stock (1)

The taxpayer requested an agreement concerning the sale of the stock in its subsidiary for cash. A closing agreement was

executed specifying the amount of the IRC § 338 aggregate deemed sales price.

Worthless Securities and Bad Debts (6)

The taxpayers requested an agreement regarding amounts deductible as ordinary losses on the worthlessness of stock in its subsidiary. A closing agreement was executed for each of the PFAs specifying that the stock was worthless and the amount to be deducted.

Fuel Credit (1)

The taxpayer requested an agreement regarding its fuel credits through consideration of the "placed in service" question and other issues bearing on the credits. A closing agreement was executed specifying the amount of the fuel credit to be allowed and how that amount was to be allocated to the partners.

Ordinary Versus Capital Loss on Property Sale (1)

The taxpayer requested an agreement concerning the tax consequences of the sale of two parcels of property. A closing agreement was executed specifying the amount of the losses and that they are to be characterized as ordinary losses under IRC § 1231.

Writedown of Inventory (1)

The taxpayer requested an agreement regarding the proper treatment of inventory write-downs. A closing agreement was executed specifying the amount allowable as a deduction reflected in the determination of the cost of good sold.

Deductibility of Fines and Penalties (1)

The taxpayer requested an agreement regarding the proper treatment of amounts paid to the U.S. government in restitution, civil damages, and fines. A closing agreement was executed specifying the amount allowable as restitution under IRC § 162 and the amount determined to be a fine or penalty and therefore not allowable as a deduction.

Closing Agreements

There is not a *pro forma* or model agreement for a PFA closing agreement. A PFA represents a specific matter closing agreement under IRC § 7121. The closing agreements entered into under the PFA program were prepared with assistance from the Office of Chief Counsel and conform to the guidance provided in Rev. Proc. 68–16.

PFA Program Utilization

The PFA program is available to all taxpayers under the jurisdiction of LMSB. During calendar year 2004, 38 taxpayers submitted PFA applications. These taxpayers included both Coordinated Industry Case (CIC) taxpayers that are typically subject to examination on a continuing basis and Industry Case (IC) taxpayers that are subject to examination on a less frequent basis. Of the 38 applications, 30 were from CIC taxpayers and 8 were from IC taxpayers. Of the 27 cases that resulted in closing agreements during calendar year 2004, 25 were with CIC taxpayers and 2 were with IC taxpayers.

Processing Statistics

The average elapsed time to resolve the 27 cases that resulted in closing agreements in calendar year 2004 was 360 days.

Processing Time for Twenty Seven Closing Agreements Executed in 2004	Range (Elapsed Days)	Average (Elapsed Days)
Application Screening Process	29–359*	76
PFA Evaluation Process	62–716	285
Total Time to Close a PFA Case	99–773	360

*One case took 359 days to screen because the taxpayer had not yet completed the transaction and the Service waited for the transaction to be completed before accepting the PFA. The next highest number of days for screening was 163.

Application Screening Process

The application screening process is the process to determine if an application is appropriate for inclusion in the PFA program. This screening process includes obtaining comments from various LMSB functions and Chief Counsel, the review of these comments, and the acceptance or rejection of an application by the Industry Director. The average time from the date an application was received by the IRS until the Industry Director rendered a decision to accept or reject an application was 76 days.

PFA Evaluation Process

The PFA evaluation process is the second (and final) phase in the PFA program. This phase begins when the Industry Director accepts an application into the PFA program and ends when a PFA closing agreement is executed or the process terminates as a result of a withdrawal. The average elapsed time during the PFA evaluation process for the 27 cases that resulted in closing agreements in calendar year 2004 was 285 days.

Program Evaluation

The PFA Program Manager ensures that an evaluation of all of the PFA program cases, based on feedback from LMSB employees and taxpayer participants, is solicited. As part of this program evaluation, LMSB and taxpayer participants were asked to provide the direct examination time expended to complete the PFA and an estimate of the direct examination time it would have taken to resolve the issue in a post-filing context. The table below indicates the results for those that provided a response since the program's inception.

Cumulative Hours on Executed PFAs	Taxpayer (Hours)	LMSB (Hours)
Actual Hours Expended — PFA Process	20,243	16,897
Estimated Hours Required To Be Expended — Post-Filing Process	38,615	22,978
Time Savings — Actual PFA Process versus Estimated Post-Filing	18,372	6,081
Average Percentage Savings — Actual PFA Process versus Estimated Post-Filing	47.6%	26.5%

Comparative Analysis — Processing Statistics

The average total time to conclude the 27 cases that resulted in closing agreements in calendar year 2004 was 360 days. Illustrated below are the processing statistics for the cases that resulted in closing agreements since the inception of the program.

Average Processing Time (Days)	Overall Pilot (11 cases)	Program CY 2001 (7 cases)	Program CY 2002 (12 cases)	Program CY 2003 (18 cases)	Program CY 2004 (27 cases)
Application Screening Process	38	47	53	59	76
PFA Evaluation Process	242	126	183	240	285
Total Time to Complete a PFA	281	173	235	299	360

The increased processing time can be attributed to the greater degree of complexity of the issues and the time necessary to develop the factual background. Generally, the more complex and fact intensive the issue is, the greater the time necessary to complete the process.

Taxpayer Satisfaction Survey

An additional aspect of the evaluation process is soliciting feedback from taxpayers regarding satisfaction with the PFA process through a questionnaire. Responses to the questionnaire were received from 11 of the 27 taxpayers who executed closing agreements for calendar year 2004. Taxpayers were asked to rate the PFA process on a scale of 1 to 5. The responses are summarized below.

Overall level of satisfaction with the PFA process.						**Average 4.7**
	Very Dissatisfied	Dissatisfied	Neither	Satisfied	Very Satisfied	Does Not Apply
number				3	7	1
percentage				27.3	63.6	9.1
Likelihood of taxpayer recommending the PFA process to others.						**Average 4.6**
	Very Unlikely	Unlikely	Perhaps	Likely	Very Likely	Does not Apply
number				4	7	
percentage				36.4	63.6	
The PFA process was clearly communicated during the orientation session.						**Average 4.4**
	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number				6	4	1
percentage				54.5	36.4	9.1

During the orientation, questions regarding the PFA process were completely addressed. **Average 4.4**

	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number				7	4	
percentage				63.6	36.4	

The PFA audit plan was developed with input from both the IRS and the taxpayer. **Average 4.5**

	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number				6	5	
percentage				54.5	45.5	

The IRS requests for information were relevant to resolve the PFA issue. **Average 4.4**

	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number				7	4	
percentage				63.6	36.4	

The time taken by the IRS to review information during the entire "Factual development" stage of the PFA process was appropriate. **Average 4.3**

	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number		1		5	5	
percentage		9.1		45.5	45.5	

The time taken by the IRS to complete the "Closing Agreement" stage of the PFA process was appropriate. **Average 4.0**

	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number		1	1	6	3	
percentage		9.1	9.1	54.5	27.3	

IRS team members were accessible during the process to resolve the PFA issue. **Average 4.5**

	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number			1	4	6	
percentage			9.1	36.6	54.5	

The total number of staff days or hours actually expended as compared to expected staff days or hours.						**Average 4.0**
	Significantly More	More	About the Same	Less	Significantly Less	Does Not Apply
number		1	2	4	4	
percentage		9.1	18.2	36.4	36.4	
The total elapsed time to complete the PFA process as compared to the expected time to complete the process.						**Average 3.8**
	Significantly More	More	About the Same	Less	Significantly Less	Does Not Apply
number	1	1	1	3	4	1
percentage	9.1	9.1	9.1	27.3	36.4	9.1
The spirit of cooperation between IRS and the company as a result of the PFA process.						**Average 4.1**
	Significantly Less	Less	About the Same	Improved	Significantly Improved	Does Not Apply
number			2	6	3	
percentage			18.2	54.5	27.3	
The ability to reach agreement at the lowest (managerial) level.						**Average 4.1**
	Significantly Less	Less	About the Same	Improved	Significantly Improved	Does Not Apply
number			2	6	3	
percentage			18.2	54.5	27.3	
The ease of effort in reaching agreement compared to the expected ease on post-filing.						**Average 4.0**
	Significantly Less	Less	About the Same	Improved	Significantly Improved	Does Not Apply
number			2	7	2	
percentage			18.2	63.6	18.2	
Monetary costs incurred to resolve the issue compared to expected costs to resolve issues through the post-filing process.						**Average 3.6**
	Significantly More	More	About the Same	Less	Significantly Less	Does Not Apply
number		2	2	5	2	
percentage		18.2	18.2	45.5	18.2	

The ability to present an accurate tax return for financial statement purposes as a result of the pre-filing process.						**Average 4.1**
	Significantly Less	Less	About the Same	Improved	Significantly Improved	Does Not Apply
number			2	5	3	1
percentage			18.2	45.5	27.3	9.1

Pre-Filing Agreement Program Summary

Overall, the PFA program is meeting the LMSB strategic program objectives as provided in its issue management strategic initiative. The following benchmarks reflect the overall progress of the PFA program:

- The increasing number of issues resolved through the PFA program, which has grown steadily since the program became fully operational;
- The high degree of overall satisfaction of taxpayers participating in the PFA program and the likelihood that those participants would recommend this process to other taxpayers.

Although the number of cases resolved in the PFA program increased in 2004, the total processing time has also increased. Revenue Procedure 2005–12 now imposes short time frames for evaluating a PFA, so we expect the time for the application screening process to decline significantly. The time during the PFA evaluation process continues to increase. This trend, which is due in part to the increasing complexity of issues presented by taxpayers for PFA consideration, has continued since the PFA program became fully operational in 2001.

The principal author of this announcement is Melanie Perrin, Office of Pre-Filing and Technical Guidance, Large and Mid-Size Business Division. For further information regarding this announcement, contact Ms. Perrin at (202) 283–8408.

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

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