

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. 2006-57, page 911.

Qualified transportation fringes; smartcards and debit cards. This ruling provides guidance to employers on the use of smartcards and debit cards to provide qualified transportation fringes under section 132(f) of the Code.

T.D. 9292, page 914.

Final regulations under section 704 of the Code provide that allocations of creditable foreign tax expenditures cannot have substantial economic effect, and, therefore, must be allocated in accordance with the partners' interests in the partnership. The regulations provide a safe harbor whereby allocations of creditable foreign tax expenditures will be deemed to be in accordance with the partners' interests in the partnership. To satisfy the safe harbor, allocations of creditable foreign tax expenditures must be in proportion to the distributive shares of income to which the taxes relate.

REG-141901-05, page 947.

Proposed regulations under section 72 of the Code provide guidance on taxation of the exchange of property for an annuity contract. The regulations would apply the same rule to exchanges for both private annuities and commercial annuities, but the regulations would not affect charitable gift annuities. A public hearing is scheduled for February 16, 2007.

REG-136806-06, page 950.

Proposed regulations under section 141 of the Code provide guidance relating to the standards for treating payments in lieu of taxes as generally applicable taxes for purposes of the private security or payment test. A public hearing is scheduled for February 13, 2007.

Notice 2006-101, page 930.

This notice updates Notice 2003-69, 2003-2 C.B. 851, which contains a list of the United States tax treaties that meet the requirements of section 1(h)(11)(C)(i)(II) of the Code. Notice 2003-69 amplified and superseded.

Rev. Proc. 2006-42, page 931.

This document provides rules for taxpayers to obtain automatic approval to change certain elections to apportion interest expense and research and experimentation expense under section 861 of the Code as a result of new rules under the section 199 domestic production activities deduction.

Rev. Proc. 2006-51, page 945.

This procedure amplifies Rev. Proc. 2005-70, 2005-47 I.R.B. 979, to provide the maximum amount of foreign earned income, as adjusted for inflation, that may be excluded from gross income under section 911 of the Code for taxable years beginning in 2006. Rev. Proc. 2005-70 amplified.

ADMINISTRATIVE

Notice 2006-103, page 931.

Because Patriots' Day falls on Monday, April 16, this notice provides individual taxpayers residing in Maine, Maryland, Massachusetts, New Hampshire, New York, Vermont, and the District of Columbia an additional day to file their federal income tax returns and make their payments (until April 17, 2007). The additional day applies to the payment of the first installment of estimated tax for 2007.

(Continued on the next page)

Finding Lists begin on page ii.



Rev. Proc. 2006-48, page 934.

Guidance is provided concerning when information shown on a return in accordance with the applicable forms and instructions will be adequate disclosure for purposes of reducing an understatement of income tax under sections 6662(d) and 6694(a) of the Code.

Rev. Proc. 2006-49, page 936.

Optional standard mileage rates. This procedure announces 48.5 cents as the optional rate for deducting or accounting for expenses for business use of an automobile, 14 cents as the optional rate for use of an automobile as a charitable contribution, and 20 cents as the optional rate for use of an automobile as a medical or moving expense for 2007. The procedure also provides rules for substantiating the deductible expenses of using an automobile for business, moving, medical, or charitable purposes. Rev. Proc. 2005-78 superseded.

Rev. Proc. 2006-50, page 944.

Substantiation of expenses of Native Alaskan whaling captains. This document provides the procedures for the substantiation of whaling expenses of an individual recognized as a whaling captain by the Alaska Eskimo Whaling Commission.

Announcement 2006-90, page 953.

This document contains corrections to a notice of proposed rulemaking (REG-124152-06, 2006-36 I.R.B. 368) and notice of public hearing relating to the determination of who is considered to pay a foreign tax for purposes of sections 901 and 903 of the Code.

Announcement 2006-91, page 953.

This document contains corrections to final and temporary regulations (T.D. 9244, 2006-8 I.R.B. 463) under sections 358 and 1502 of the Code regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions.

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 62.—Adjusted Gross Income Defined

26 CFR 1.62-2: *Reimbursements and other expense allowance arrangements.*

Rules are provided under which a reimbursement or other expense allowance arrangement for the cost of operating an automobile for business purposes will satisfy the requirements of section 62(c) of the Code as a business connection, substantiation, and returning amounts in excess of expenses. See Rev. Proc. 2006-49, page 936.

Section 132.—Certain Fringe Benefits

26 CFR 1.132-9: *Qualified Transportation Fringes.* (Also: 3121(a)(20), 3306(b)(16), 3401(a)(19).)

Qualified transportation fringes; smartcards and debit cards. This ruling provides guidance to employers on the use of smartcards and debit cards to provide qualified transportation fringes under section 132(f) of the Code.

Rev. Rul. 2006-57

ISSUE

Whether, under the facts described, employer-provided transportation benefits provided through smartcards, debit or credit cards, or other electronic media are excluded from gross income under §§ 132(a)(5) and 132(f) of the Internal Revenue Code and from wages for employment tax purposes.

FACTS

Situation 1. For 2006, Employer A provides to its employees transportation benefits in an amount not exceeding \$105 each month. Transit system X provides smartcards that may be used by employers in the metropolitan area served by X as a mechanism to provide fare media for transit system X to employees. The smartcards are plastic cards containing a memory chip that stores certain information including the serial number of the card and the value of the fare media stored on the card. The amount stored as fare media on the smartcard is not authorized to be

used to purchase anything other than fare media for X. A uses the smartcards as a mechanism to provide transportation benefits to its employees. A makes monthly payments to X on behalf of its employees who participate in the transportation benefit program, which X then electronically allocates to each employee's smartcard as instructed by A. A does not require its employees to substantiate their use of the smartcards.

Situation 2. For 2006, Employer B provides to its employees transportation benefits in an amount not exceeding \$105 each month. Debit card provider P provides debit cards that may be used by employers to provide transportation benefits to their employees. The debit cards are restricted for use only at merchant terminals at points of sale at which only fare media for transit system Y is sold. B uses the terminal-restricted debit cards provided by P as a mechanism to provide transportation benefits to its employees. B makes monthly payments to P on behalf of its employees who participate in the transportation benefit program, which P then electronically allocates to each employee's terminal-restricted debit card as instructed by B. B does not require its employees to substantiate their use of the debit cards.

Situation 3. For 2006, Employer C provides to its employees transportation benefits in an amount not exceeding \$105 each month. Debit card provider Q provides debit cards that may be used by employers as a mechanism to provide transportation benefits to their employees. Q restricts the use of the debit cards to merchants that have been assigned a merchant category code (MCC) indicating that the merchant sells fare media. The cards are restricted for use at merchants that have been assigned MCCs indicating the merchant sells fare media for some or all of the following categories: local and suburban commuter passenger transport; passenger railway; bus lines, excluding charters and tours; and transportation service (not elsewhere classified). The merchant may or may not sell other merchandise. The MCCs were developed by S, which is a debit/credit card network. S determines and updates the MCC assigned to

a particular merchant based on information provided by the merchant. C uses the MCC-restricted debit cards provided by Q as a mechanism to provide transportation benefits to its employees. A voucher or similar item exchangeable only for a transit pass is not otherwise readily available for purchase by C for direct distribution to C's employees within the meaning of § 132(f)(3).

For the first month an employee participates in the transportation benefit program, the employee pays for fare media with after-tax amounts. The employee then substantiates to C the amount of fare media expenses incurred during the month following reasonable substantiation procedures implemented by C as described in § 1.132-9(b) Q/A-16(c). C then remits to Q an amount equal to the amount of substantiated fare media expenses for the prior month, which Q then electronically allocates to the debit card assigned to the employee. For subsequent months, C reimburses the employee for fare media expenses incurred by the employee by providing funds to Q to be allocated to the employee's debit card equal to the amount of fare media expenses substantiated under the following procedures (not exceeding the monthly limit provided under § 132(f)(2)). With respect to expenses for which employees seek reimbursement that were paid using the MCC-restricted debit card, C receives periodic statements providing information on the use of each debit card, which include information on the identity of the merchants at which the debit card was used, and the date and amount of the debit card transactions. In addition, for the first month the debit card was used, prior to providing reimbursement, C requires that the employee certify that the debit card was used only to purchase fare media. For subsequent months, C does not require employee certifications prior to reimbursement of recurring expenses that match expenses previously substantiated under the procedures described above as to seller and time period (e.g., for an employee who purchases a transit pass on a regular basis from the same seller). However, C requires a recertification at least annually from each

employee that the debit card was used only to purchase fare media. C reviews the periodic statements in combination with the employee certifications to determine the transit pass expenses incurred by each employee through the use of the debit card and reimburses each employee for the expenses that have been substantiated by transmitting funds to Q to be allocated electronically to each employee's debit card. With respect to fare media expenses for which C's employees seek reimbursement that were not paid using the MCC-restricted debit card, the employees substantiate the amount of the fare media expenses incurred following reasonable substantiation procedures implemented by C as described in § 1.132-9(b) Q/A-16(c). For example, an employee receiving reimbursements of less than the maximum monthly excludable amount of transportation expenses may increase his or her reimbursements for future months by paying for increased fare media expenses by some method other than the use of the debit card and substantiating the additional amount using reasonable substantiation procedures as described in § 1.132-9(b) Q/A-16(c).

Situation 4. The facts are the same as in Situation 3, except in the following respects. Employer C provides employees with MCC-restricted debit cards as soon as they begin work. Prior to using the MCC-restricted debit cards, C's employees certify that the card will be used only to purchase transit passes. In addition, written on each debit card is the statement that the card is to be used only for transit passes, and, by using the card, the employee certifies that the card is being used only to purchase transit passes. At no time do C's employees substantiate to C the amount of fare media expenses that have been incurred.

LAW

Section 61(a)(1) of the Code provides that, except as otherwise provided in subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 132(a)(5) provides that any fringe benefit that is a qualified transportation fringe is excluded from gross income. Section 132(f)(1) provides that the term "qualified transportation fringe" means

(1) transportation in a commuter highway vehicle between home and work, (2) any transit pass, and (3) qualified parking. The amount of the fringe benefit which may be excluded from gross income and wages for 2006 is limited to \$105 per month for the aggregate of transportation in a commuter highway vehicle and transit passes, and \$205 per month for qualified parking. See § 132(f)(2); Rev. Proc. 2005-70, 2005-47 I.R.B. 979, § 3.12.

Section 132(f)(5)(A) provides that a transit pass is any pass, token, farecard, voucher or similar item entitling a person to transportation (or transportation at a reduced price) if such transportation is on mass transit facilities or is provided by any person in the business of transporting persons for compensation or hire in a commuter highway vehicle. See § 132(f)(5)(B) for the definition of a commuter highway vehicle.

Section 132(f)(3) provides that a qualified transportation fringe includes a cash reimbursement by an employer to an employee for transit benefits. However, a qualified transportation fringe includes a cash reimbursement by an employer to an employee for a transit pass only if a voucher or similar item that may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Section 1.132-9(b) Q/A-16(b)(1) of the Income Tax Regulations provides that if a voucher or similar item is readily available, the requirement that a voucher or similar item be distributed in-kind by the employer is satisfied if the voucher is distributed by the employer or by another person on behalf of the employer (for example, if a transit operator credits amounts to the employee's fare card as a result of payments made to the operator by the employer).

Section 1.132-9(b) Q/A-16(b)(2) provides that a transit system voucher is an instrument that may be purchased by employers from a voucher provider that is accepted by one or more mass transit operators in an area as fare media or in exchange for fare media. Under § 1.132-9(b) Q/A-16(b)(3), a voucher provider is any person in the trade or business of selling transit system vouchers to employers, or any transit system or transit system operator that sells vouchers to employers for the

purpose of direct distribution to employees.

Section 1.132-9(b) Q/A-16(b)(4) provides that a voucher or similar item is readily available for direct distribution by an employer to employees if and only if the employer can obtain it from a voucher provider that does not impose fare media charges greater than 1 percent of the average annual value of the voucher for a transit system, and does not impose other restrictions causing the voucher not to be considered readily available. See § 1.132-9(b) Q/A-16(b)(5) and (b)(6).

Section 1.132-9(b) Q/A-16(a) provides that the term qualified transportation fringe includes cash reimbursement for transportation in a commuter highway vehicle, transit passes (if permitted), and qualified parking, provided the reimbursement is made under a *bona fide* reimbursement arrangement. A payment made before the date an expense has been incurred or paid is not a reimbursement. In addition, a *bona fide* reimbursement arrangement does not include an arrangement that is dependent solely on the employee certifying in advance that the employee will incur expenses at some future date. Under § 1.132-9(b) Q/A-16(c), whether a reimbursement is made under a *bona fide* reimbursement arrangement depends upon the facts and circumstances. The employer must implement reasonable procedures to ensure that the amount equal to the reimbursement was incurred for transportation in a commuter highway vehicle, transit passes, or qualified parking. Section 1.132-9(b) Q/A-16(d) provides that reasonable reimbursement procedures include the collection of receipts from employees or obtaining employee certifications in appropriate circumstances. The regulations provide that obtaining an employee's certification is a reasonable reimbursement procedure if receipts are not provided by the seller in the ordinary course of business, and if the employer has no reason to doubt the employee's certification.

Section 1.132-9(b) Q/A-18 provides that there are no employee substantiation requirements if an employer distributes a transit pass (including a voucher or similar item) in-kind to the employer's employees.

Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax

Act (FUTA) taxes, and Federal income tax withholding are imposed on “wages.” See §§ 3101, 3111, 3121(a), 3301, 3306(b), 3402, and 3401(a). Section 3121(a) defines “wages” for FICA purposes as all remuneration for employment including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Sections 3306(b) and 3401(a) define “wages” similarly for FUTA and Federal income tax withholding purposes respectively.

Section 3121(a)(20) excepts from the definition of “wages” for FICA tax purposes any benefit provided to or on behalf of an employee if, at the time such benefit is provided, it is reasonable to believe that the employee will be able to exclude such benefit from gross income under § 132. Sections 3306(b)(16) and 3401(a)(19) provide similar exclusions for FUTA and Federal income tax withholding purposes respectively.

ANALYSIS

In Situation 1, the fare media value stored on the smartcards is useable only as fare media for transit system X. Thus, the smartcard qualifies as a transit system voucher under § 1.132-9(b) Q/A-16(b)(2) distributed in-kind by A to its employees. In addition, the amount allocated to each employee’s smartcard is within the amount specified by § 132(f)(2)(A). Accordingly, the value of the fare media provided by A to its employees through the use of the smartcards is excluded from the employees’ gross income as a qualified transportation fringe benefit within the meaning of § 132(a)(5) without requiring the employees to substantiate their use of the smartcards.

In Situation 2, the terminal-restricted debit card provided by B to its employees qualifies as a transit system voucher under § 1.132-9(b) Q/A-16(b)(2) because it can be used only at merchant terminals at points of sale at which only fare media for transit system Y can be purchased. In addition, the amount allocated to each employee’s debit card each month is within the amount specified by § 132(f)(2)(A). Therefore, the value of the fare media provided by B to its employees through the use of the terminal-restricted debit cards is excluded from its employees’ gross in-

come as a qualified transportation fringe benefit within the meaning of § 132(a)(5) without requiring the employees to substantiate their use of the debit cards.

In Situation 3, the debit card provided by C to its employees does not qualify as a transit system voucher under § 1.132-9(b) Q/A-16(b)(2) because it is possible that a MCC-restricted debit card may be used to purchase items other than transit passes. A merchant properly classified to accept the debit card as payment may sell merchandise other than transit passes, and there is nothing in the debit card technology which prevents its use to purchase things other than transit passes.

Because a voucher or similar item exchangeable only for fare media is not readily available to C for direct distribution to its employees, § 132(f)(3) permits C to provide qualified transportation benefits in the form of cash reimbursements for transit pass expenses, but only if the reimbursements are provided under a *bona fide* reimbursement arrangement. With respect to expenses incurred during the first month an employee participates in the transportation benefit program, and with respect to expenses not paid using the MCC-restricted debit card, C has implemented reasonable substantiation procedures as described in § 1.132-9 Q/A-16(c). With respect to expenses paid using the MCC-restricted debit card, C receives periodic statements providing information on the purchases made with the debit card, including the identity of the seller, and the date and amount of the debit card transactions. In addition, for the first month an employee uses the MCC-restricted debit card, C requires that the employee certify that the card was used only to purchase fare media. C does not require monthly certifications with respect to recurring items if the item described in the periodic statement matches with respect to seller and time period items that have previously been substantiated as transit pass expenses. However, C requires at least an annual recertification from each employee that the debit card was used only to purchase fare media. Prior to remitting an amount to Q as reimbursement for transit pass expenses for an employee, C examines the periodic statements describing debit card transactions in combination with employee certifications to determine the transit pass expenses incurred by each

employee through the use of the debit card. C provides funds to Q to be electronically allocated to the debit cards only as reimbursements for substantiated transit pass expenses that have been incurred and substantiated in this fashion. Based on the facts and circumstances, C has established a *bona fide* reimbursement arrangement for transit passes within the meaning of § 1.132-9 Q/A-16(c). In addition, the amount of the monthly benefit is within the amount specified by § 132(f)(2)(A). Therefore, the value of the fare media provided by C to its employees through the use of the MCC-restricted debit cards is excluded from its employees’ gross income as a qualified transportation fringe benefit within the meaning of § 132(a)(5).

In Situation 4, as discussed above, the MCC-restricted debit card does not qualify as a transit system voucher under § 1.132-9(b) Q/A-16(b)(2). Because a voucher or similar item is not otherwise readily available to C, C may provide qualified transportation fringe benefits in the form of cash reimbursements for transit passes under a *bona fide* reimbursement arrangement. C provides the debit cards in advance, requiring its employees to certify that they will use the cards exclusively to purchase transit passes. This arrangement does not constitute a *bona fide* reimbursement arrangement under § 1.132-9(b) Q/A-16(c) because it provides for advances rather than reimbursements and because it relies solely on employee certifications provided before the expense is incurred. Those certifications, standing alone, do not provide the substantiation of expenses incurred necessary for there to be a *bona fide* reimbursement arrangement. Because C is providing restricted-use debit cards that are not transit system vouchers, and because C is not reimbursing its employees for fare media expenses under a *bona fide* reimbursement arrangement, the amounts C provides to its employees through the use of the MCC-restricted debit cards are included in its employees’ gross income and wages.

HOLDINGS

Situation 1. The value of the transit pass benefits provided by A to its employees through the use of the smartcards is excluded from gross income under

§ 132(a)(5) and from wages for employment tax purposes.

Situation 2. The value of the transit pass benefits provided by B to its employees through the use of the terminal-restricted debit card is excluded from gross income under § 132(a)(5) and from wages for employment tax purposes.

Situation 3. The value of the transit pass benefits provided by C to its employees through the use of the MCC-restricted debit card is excluded from gross income under § 132(a)(5) and from wages for employment tax purposes.

Situation 4. The amounts provided by C to its employees through the use of the MCC-restricted debit cards are not excluded from gross income under § 132(a)(5) and are wages for employment tax purposes.

EFFECTIVE DATE

This revenue ruling is effective January 1, 2008. Employers and employees may rely on this revenue ruling with respect to transactions occurring prior to January 1, 2008. As discussed in Notice 2004-46, 2004-2 C.B. 46, if a debit card qualifies as a voucher or similar item, then cash reimbursement for transit pass expenses would be precluded if such a debit card were readily available. The Treasury Department and the Internal Revenue Service will continue to review this issue, including the circumstances under which a terminal-restricted debit card may be considered not readily available because of implementation charges or other restrictions within the meaning of § 1.132-9(b) Q/A-16(b)(6) that effectively prevent the employer from obtaining the debit card for distribution to employees.

As terminal-restricted debit cards appear not to be widely used at present in areas where cash reimbursement is permissible, the Treasury Department and the Internal Revenue Service lack sufficient factual context to develop guidance at this time regarding when terminal-restricted debit cards are readily available. As use of terminal-restricted debit cards increases in cash-reimbursement areas, we intend to issue guidance clarifying under what situations the cards are considered to be readily available and thus preclude cash reimbursement for transit benefits. Until

such guidance is issued, the Service will not challenge the ability of employers to provide qualified transportation fringes in the form of cash reimbursement for transit passes when the only available voucher or similar item is a terminal-restricted debit card.

DRAFTING INFORMATION

The principal authors of this revenue ruling are David R. Ford and John Richards of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact John Richards at (202) 622-6040 (not a toll-free call).

Section 162.—Trade or Business Expenses

26 CFR 1.162-17: Reporting and substantiation of certain business expenses of employees.

Rules are provided for substantiating the amount of a deduction for an expense for business use of an automobile. See Rev. Proc. 2006-49, page 936.

Section 170.—Charitable, etc., Contributions and Gifts

26 CFR 1.170A-1: Charitable, etc., contributions and gifts; allowance of deduction.

Rules are provided for substantiating the amount of a deduction for an expense for charitable use of an automobile. See Rev. Proc. 2006-49, page 936.

Section 213.—Medical, Dental, etc., Expenses

26 CFR 1.213-1: Medical, dental, etc., expenses.

Rules are provided for substantiating the amount of a deduction for an expense for use of an automobile to obtain medical services. See Rev. Proc. 2006-49, page 936.

Section 217.—Moving Expenses

26 CFR 1.217-2: Moving expenses.

Rules are provided for substantiating the amount of a deduction for an expense for use of an automobile as part of a move. See Rev. Proc. 2006-49, page 936.

Section 274.—Disallowance of Certain Entertainment, etc., Expenses

26 CFR 1.274-5: Substantiation requirements.

Rules are provided for substantiating the amount of ordinary and necessary business expenses of an employee for automobile expenses when a payor provides a mileage allowance for the expenses. Rules are also provided for employees and self-employed individuals to use in substantiating a trade or business deduction for automobile expenses. See Rev. Proc. 2006-49, page 936.

Section 704.—Partner's Distributive Share

26 CFR 1.704-1: Partner's distributive share.

T.D. 9292

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Partner's Distributive Share: Foreign Tax Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations regarding the allocation of creditable foreign tax expenditures by partnerships. The regulations are necessary to clarify the application of section 704(b) to allocations of creditable foreign tax expenditures. The final regulations affect partnerships and their partners.

DATES: *Effective Date:* These regulations are effective October 19, 2006.

Applicability Date: These regulations apply to partnership taxable years beginning on or after October 19, 2006.

FOR FURTHER INFORMATION CONTACT: Timothy J. Leska at 202-622-3050 or Michael I. Gilman at 202-622-3850 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 704 of the Internal Revenue Code (Code). On April 21, 2004, temporary regulations (T.D. 9121, 2004-1 C.B. 903) relating to the proper allocation of partnership expenditures for foreign taxes were published in the **Federal Register** (69 FR 21405). A notice of proposed rulemaking (REG-139792-02, 2004-1 C.B. 926) cross-referencing the temporary regulations was also published in the **Federal Register** (69 FR 21454) on April 21, 2004. A public hearing was requested and held on September 14, 2004. The IRS received a number of written comments responding to the temporary and proposed regulations. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision and the corresponding temporary regulations are removed.

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided, be determined by the partnership agreement. Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if the allocation to a partner under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect. Thus, in order to be respected, partnership allocations either must have substantial economic effect or must be in accordance with the partners' interests in the partnership.

In general, for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that, in the event there is an economic burden or benefit that corresponds to the allocation, the partner to whom the allocation is made must receive the economic benefit or bear such economic burden. See §1.704-1(b)(2)(ii). As a general rule, the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be re-

ceived, independent of tax consequences. See §1.704-1(b)(2)(iii). Even if the allocation affects substantially the dollar amounts, the economic effect of the allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. See §1.704-1(b)(2)(iii).

The temporary and proposed regulations clarified the application of the regulations under section 704 to foreign taxes paid or accrued by a partnership and eligible for credit under section 901(a) (creditable foreign tax expenditures or CFTEs). While allocations of CFTEs that are disproportionate to the related income may have economic effect in that they reduce the recipient partner's capital account and affect the amount the recipient partner is entitled to receive on liquidation, this effect will almost certainly not be substantial after taking U.S. tax consequences into account. For example, the after-tax economic consequences to a foreign or other tax-indifferent partner whose share of the tax expense is borne by a U.S. taxable partner will be enhanced by reason of the allocation, and there is a strong likelihood that the after-tax economic consequences to a U.S. partner will not be substantially diminished since the allocation of the CFTE increases the allowable foreign tax credit and results in a dollar-for-dollar reduction in the U.S. tax the partner would otherwise owe.

The temporary and proposed regulations were based on the assumption that partnerships specially allocate foreign taxes where the recipient partner would elect to claim the CFTE as a credit, rather than as a deduction. As a matter of administrative convenience, the regulations applied to all allocations of CFTEs even though, in rare instances, a partner may instead elect to deduct the CFTEs. Thus, the temporary and proposed regulations

provided that partnership allocations of CFTEs cannot have substantial economic effect and, therefore, must be allocated in accordance with the partners' interests in the partnership.

The temporary and proposed regulations provided a safe harbor under which partnership allocations of CFTEs will be deemed to be in accordance with the partners' interests in the partnership. Under this safe harbor, if the partnership agreement satisfies the requirements of §1.704-1(b)(2)(ii)(b) or (d) (capital account maintenance, liquidation according to capital accounts, and either deficit restoration obligations or qualified income offsets), then an allocation of CFTEs that is proportionate to a partner's distributive share of the partnership income to which such taxes relate (including income allocated pursuant to section 704(c)) will be deemed to be in accordance with the partners' interests in the partnership. If the allocation of CFTEs does not satisfy this safe harbor, then the allocation of CFTEs will be tested under the partners' interests in the partnership standard set forth in §1.704-1(b)(3).

Summary of Comments and Explanation of Provisions

These final regulations retain the provisions of the proposed and temporary regulations excluding allocations of CFTEs from the substantial economic effect safe harbor of §1.704-1(b)(2), and provide a safe harbor under which allocations of CFTEs will be deemed to be in accordance with the partners' interests in the partnership. As provided in the temporary and proposed regulations, the final regulations provide that allocations of CFTEs must be in proportion to the distributive shares of income to which the CFTEs relate in order to satisfy the safe harbor.

The final regulations provide that the income to which a CFTE relates is the net income in the CFTE category to which the CFTE is allocated and apportioned. A CFTE category is a category of net income attributable to one or more activities of the partnership. The net income in a CFTE category is the net income determined for U.S. federal income tax purposes (U.S. net income) attributable to each separate activity of the partnership that is included in the CFTE category. Income from separate ac-

tivities is included in the same CFTE category only if the U.S. net income from the activities is allocated among the partners in the same proportions. For this purpose, income from a divisible part of a single activity that is shared in a different ratio than other income from that activity is treated as income from a separate activity. CFTEs are allocated and apportioned to CFTE categories in accordance with §1.904-6 principles, as modified by the final regulations. Therefore, CFTEs generally are allocated to a CFTE category if the income on which the CFTE is imposed (the net income recognized for foreign tax purposes) is in the CFTE category.

Accordingly, the safe harbor of the final regulations requires a three-step process to determine the distributive share of income to which a CFTE relates. First, the partnership must determine its CFTE categories. Second, the partnership must determine the U.S. net income in each CFTE category. Third, the partnership must allocate and apportion CFTEs to the CFTE categories based on the net income in the CFTE categories that is recognized for foreign tax purposes. To satisfy the safe harbor, the partnership must allocate CFTEs among the partners in the same proportion as the allocations of U.S. net income in the applicable CFTE category.

Summary of Comments

A number of comments were received on the temporary and proposed regulations. The comments included requests for clarification and recommendations relating to the following: (i) the definition of CFTEs, (ii) the CFTE categories, (iii) the distributive share of income to which a CFTE relates, (iv) the application of the principles of §1.904-6, (v) the partners' interests in the partnership, (vi) the effective date and transition rule and (vii) certain other matters. The comments and final regulations are discussed in detail below.

A. Creditable Foreign Tax Expenditures (CFTEs)

The temporary and proposed regulations provide that a CFTE is a foreign tax paid or accrued by a partnership that is eligible for a credit under section 901(a). A qualifying domestic corporate shareholder may claim a credit under section 901(a) for

taxes paid or accrued by a foreign corporation and deemed paid by the shareholder under section 902 or 960 upon distribution or inclusion of the associated earnings. Several commentators requested guidance concerning whether taxes deemed paid under section 902 or 960 are subject to these regulations. Although a domestic corporation may be eligible to claim a credit for deemed-paid taxes with respect to stock of a foreign corporation it owns indirectly through a partnership, any such deemed-paid taxes are determined directly by the corporate partner based on the partner's distributive share of dividend income or inclusion. Such deemed-paid taxes, therefore, are not partnership items and are not taxes paid or accrued (or deemed paid or accrued) by a partnership. Accordingly, foreign taxes deemed paid under section 902 or 960 are not subject to these regulations.

The final regulations retain the definition of CFTE contained in the temporary and proposed regulations. In response to the comment, the final regulations clarify that a CFTE does not include foreign taxes deemed paid by a corporate partner under section 902 or 960. The final regulations also clarify that the regulations do not apply to foreign taxes paid or accrued by a partner (foreign taxes for which the partner has legal liability within the meaning of §1.901-2(f)). Finally, the final regulations clarify that a CFTE does include a foreign tax paid or accrued by a partnership that is eligible for a credit under an applicable U.S. income tax treaty.

B. CFTE Categories

Examples in the temporary and proposed regulations illustrated that the determination of the income to which a CFTE relates must be made separately for certain categories of income when the partnership agreement provides for different allocations of such income. Commentators requested additional guidance regarding the relevant categories for purposes of the safe harbor, including clarification that the safe harbor does not require the partnership to determine its CFTE categories by reference to section 904(d) categories. Subject to the requirements of section 704(b) and other applicable provisions of U.S. law, partners are free to allocate income in any manner they choose.

Although partners must assign their distributive shares of partnership items (along with their other items of income and expense) to section 904(d) categories to compute the applicable limitations on the foreign tax credit, the CFTE categories need not be determined by reference to section 904(d) categories. These principles were illustrated by the examples in the temporary and proposed regulations. However, the IRS and the Treasury Department agree with commentators that it is appropriate to provide additional guidance in determining a partnership's relevant categories of income. Accordingly, the final regulations provide additional guidance for purposes of making this determination. The additional guidance is also intended to assist in the determination of the distributive share of income to which a foreign tax relates. See the discussion at section C in this preamble. Consistent with the comments, the rules provided for in the final regulations rely to the extent possible on U.S. tax principles.

The final regulations clarify that the relevant category of income is the CFTE category, defined in the final regulations as U.S. net income attributable to one or more activities of the partnership. In general, the final regulations provide that U.S. net income from all of the partnership's activities is treated as income in a single CFTE category. This general rule does not apply, however, if the partnership agreement provides for an allocation of U.S. net income from one or more activities that differs from the allocation of U.S. net income from other activities. In that case, U.S. net income from each activity or group of activities that is subject to a different allocation is treated as net income in a separate CFTE category. For this purpose, income from a divisible part of a single activity is treated as income from a separate activity if such income is shared in a different ratio than other income from the activity.

Thus, if a partnership agreement allocates all partnership items in the same manner, the partnership will have a single CFTE category, regardless of the number of activities in which the partnership is engaged. Conversely, a partnership agreement that provides for different allocations of net income with respect to one or more activities will have multiple CFTE categories. For example, assume a partnership (AB) with two partners is

engaged in two activities and that the partnership agreement provides that all partnership items are shared 50–50. In such a case, the partnership has a single CFTE category. However, the partnership would have two CFTE categories if the items from one activity were shared 50–50 and the items from the second activity were shared 80–20.

Different allocations of the partnership's U.S. net income from separate activities and, thus, multiple CFTE categories may result if the partnership agreement contains special allocations. For example, assume that AB partnership agreement allocates all items other than depreciation 50–50, and that deductions for depreciation are allocated 100 percent to one of the partners. In such a case, the allocations of U.S. net income from the two activities will differ if AB's deductions for depreciation relate solely to one activity or if the deductions relate disproportionately to the activities. See paragraph (b)(5) *Example 22*. A preferential allocation of income will not result in multiple CFTE categories if the allocation relates to all of the partnership's net income. For example, assume partnership AB allocates \$100 of gross income each year to one of the partners and all remaining items 50–50. In such a case, the special allocation of \$100 of gross income affects the overall sharing ratio of partnership net income, but does not result in different sharing ratios with respect to income from the partnership's two activities. Accordingly, the U.S. net income attributable to the two activities is included in a single CFTE category. See paragraph (b)(5) *Example 25*.

Whether the partnership has different sharing ratios with respect to income from one or more activities, and therefore has more than one CFTE category, depends on the facts and circumstances. Therefore, the final regulations provide that whether a partnership has one or more activities, and the scope of those activities, must be determined in a reasonable manner taking into account all the facts and circumstances. In evaluating whether aggregating or disaggregating income from particular business or investment operations constitutes a reasonable method of determining the scope of an activity, the principal consideration is whether or not the proposed determination has the effect of sep-

arating CFTEs from the related foreign income. Accordingly, relevant facts and circumstances include whether the partnership conducts business or investment operations in more than one geographic location or through more than one entity or branch, and whether certain types of income are exempt from foreign tax or subject to preferential foreign tax treatment. In addition, income from a divisible part of a single activity is treated as income from a separate activity if necessary to prevent the separation of CFTEs from the related foreign income. Finally, the final regulations provide that the partnership's activities must be determined consistently from year to year absent a material change in facts and circumstances.

C. Distributive Share of Income to Which a CFTE Relates

The temporary and proposed regulations required the allocation of a CFTE to be in proportion to the partner's distributive share of income to which it relates. Several commentators requested that the final regulations provide additional guidance in determining a partner's distributive share of income for purposes of the safe harbor. Some commentators believed that it was unclear whether allocations of CFTEs must be proportionate to allocations of income as determined for U.S. tax purposes or as determined under foreign law. One comment recommended that, at least in cases where there is a preferential allocation of income, income as determined for U.S. tax purposes should control. Other commentators requested that the final regulations clarify whether allocations of CFTEs must follow allocations of gross or net income, and that the final regulations clarify the effect of special allocations and allocations of separately stated items on allocations of CFTEs under the safe harbor. Commentators also requested clarifications regarding section 704(c) allocations, income allocations that are deductible under foreign law, guaranteed payments, and situations in which certain partners' allocable shares of partnership income are excluded from the foreign tax base. In response to the comments, the final regulations provide several clarifications regarding the determination of a partner's distributive share of income to which a CFTE relates.

1. Net income in a CFTE category

The final regulations clarify that the net income in a CFTE category is the net income for U.S. Federal income tax purposes, determined by taking into account all items attributable to the relevant activity or group of activities (or portion thereof). The final regulations provide that the items of gross income included in a CFTE category must be determined in a consistent manner under any reasonable method taking into account all the facts and circumstances. Expenses, losses or other deductions generally must be allocated and apportioned to gross income included in a CFTE category in accordance with the rules of §§1.861–8 and 1.861–8T.

Sections 1.861–8 and 1.861–8T require taxpayers to use special rules contained in §§1.861–9 through 1.861–13T and §1.861–17 to allocate and apportion deductions for interest expense and research and development (R&D) costs. See §§1.861–8(e)(3) and 1.861–8T(e)(2). Those provisions generally require taxpayers to allocate and apportion such deductions at the partner level and do not provide rules for allocating and apportioning the deductions at the partnership level. See §§1.861–9T(e) and 1.861–17(f). Therefore, the final regulations permit a partnership to allocate and apportion deductions for interest and R&D costs for purposes of determining net income in a CFTE category under any reasonable method, including but not limited to the rules contained in §§1.861–9 through 1.861–13T and §1.861–17.

The final regulations clarify that in applying U.S. Federal income tax principles to determine the net income attributable to an activity of a branch, the only items of gross income taken into account are items of gross income that are recognized by the branch for U.S. federal income tax purposes. Therefore, a payment from one branch to another does not increase the gross income attributable to the activity of the recipient. See paragraph (b)(5) *Example 24*. Similarly, because U.S. tax principles apply to determine net income attributable to an activity of a branch, the inter-branch payment does not reduce the gross income of the payor. See paragraph (b)(4)(viii)(c)(3)(B) and paragraph (b)(5) *Example 24*.

The discussion in this preamble addresses the effect of the following factors on the determination of net income in a CFTE category: (a) section 704(c) allocations, (b) preferential income allocations and guaranteed payments, and (c) the exclusion of income of certain partners from the foreign tax base.

(a) *Section 704(c) allocations*

Several commentators requested clarification of when section 704(c) allocations should be taken into account. Some commentators believed that section 704(c) allocations should only be taken into account where the built-in gain or loss is also recognized in the foreign jurisdiction. A number of commentators suggested further that section 704(c) allocations should be taken into account only upon the disposition of the section 704(c) property, while other commentators believed that section 704(c) allocations should also be taken into account as the section 704(c) property is depreciated or amortized over time.

After consideration of these comments, the final regulations retain the general principle that all section 704(c) allocations must be taken into account when determining net income in the relevant category. The IRS and the Treasury Department concluded that any attempt to trace the impact of built-in gain (or loss) under foreign tax principles to corresponding items under U.S. tax principles would be difficult to do and impractical to administer. Because allocations of net income from a CFTE category are allocations of the net income recognized for U.S. tax purposes, the IRS and the Treasury Department believe that all section 704(c) allocations (including “reverse” section 704(c) allocations and section 704(c) allocations that are made prior to an asset’s disposition) must be taken into account in determining a partner’s distributive share of income. Thus, the final regulations provide that the net income in a CFTE category is the net income for U.S. income tax purposes, determined by taking into account all items attributable to the relevant activity, including, among other items, items allocated pursuant to section 704(c). See paragraph (b)(5) *Example 26*.

(b) *Preferential income allocations and guaranteed payments*

Several commentators requested that the final regulations provide guidance regarding the treatment of preferential income allocations and guaranteed payments when applying the safe harbor. In particular, clarification was requested as to the relevance of the deductibility of such items under foreign law in determining whether CFTEs are related to such items.

The final regulations generally provide that the income to which a CFTE relates is the net income in the CFTE category to which the CFTE is allocated and apportioned. However, if an allocation of partnership income is treated as a deductible payment under foreign law, then no CFTEs are related to that income because it is not included in the foreign tax base. To reflect this principle, the final regulations provide that income attributable to an activity shall not include an item of partnership income to the extent the allocation of such item of income (or payment thereof) to a partner results in a deduction under foreign law. By removing the income associated with a preferential income allocation that is deductible under foreign law from the net income in a CFTE category, this provision of the final regulations ensures that no CFTE will be related to such income, which is not included in the base upon which the creditable foreign tax is imposed.

The principle that no CFTEs are related to income if the allocation of such income results in a deduction under foreign law applies with equal force to cases in which a guaranteed payment made by a partnership to a partner is deductible by the partnership under foreign law. Conversely, where a partner receives a guaranteed payment and the guaranteed payment is not deductible by the partnership under foreign law (and thus does not reduce the foreign tax base), CFTEs should relate to the guaranteed payment. Accordingly, the final regulations contain two provisions to reflect these principles. First, under the final regulations, a guaranteed payment is treated as income in a CFTE category to the extent that the payment is not deductible by the partnership under foreign law. Second, the final regulations provide that such a guaranteed payment is treated as a distributive share of income for purposes of the safe harbor. Consequently,

the final regulations provide that CFTEs relate to income taken into account as a guaranteed payment to the extent the payment is not deductible under foreign law, and therefore CFTEs must be allocated to the partner receiving the guaranteed payment.

One commentator requested guidance concerning the source and character of guaranteed payments for other U.S. tax purposes. These issues are clearly important, but they are beyond the scope of this project and are not addressed in these final regulations.

(c) *Taxes imposed on certain partners’ income*

A foreign jurisdiction may impose tax with respect to partnership income that is allocable to certain partners and not with respect to partnership income allocable to other partners. For example, as was the case in *Vulcan Materials Co. v. Comm’r*, 96 T.C. 410 (1991), *aff’d in unpublished opinion*, 959 F.2d 973 (11th Cir. 1992), *nonacq.* 1995–2 C.B. 2, a foreign jurisdiction may impose tax solely with respect to the nonresident partners’ shares of partnership income. One commentator suggested that the final regulations provide that in these situations, allocations of CFTEs satisfy the safe harbor if they are allocated to the partner or partners whose income is included in the foreign tax base. The final regulations adopt this comment, and provide that income in a CFTE category does not include net income that foreign law would exclude from the foreign tax base as a result of the status of the partner. By removing such income from a CFTE category, this provision of the final regulations ensures that CFTEs will be related only to income of those partners whose income is included in the base upon which the creditable foreign tax is imposed.

2. *Distributive share of income*

The final regulations provide that a partner’s distributive share of income generally is the portion of the net income in a CFTE category that is allocated to the partner. Therefore, a partner’s distributive share of income is determined under U.S. tax principles, taking into account the modifications described in section C1 under “Net income in a CFTE category.”

The final regulations provide a special rule for cases in which more than one partner receives positive income allocations (income in excess of expenses) from a CFTE category and the aggregate of such positive income allocations exceeds the net income in the CFTE category because one or more other partners is allocated a net loss (expenses in excess of income). Because in this situation the sum of the positive income allocations from the CFTE category exceeds 100 percent of the net income in the category, an adjustment to the safe harbor formula is required to ensure that aggregate allocations of CFTEs do not exceed 100 percent of the CFTEs in the category. Accordingly, solely for purposes of allocating CFTEs under the safe harbor, the final regulations limit the distributive share of income of each partner that receives a positive income allocation to the partner's positive income allocation attributable to the CFTE category, divided by the aggregate positive income allocations attributable to the CFTE category, multiplied by the net income in the CFTE category. For example, assume that the partnership has \$100 of net income (\$130 of gross income and \$30 of expenses) in a CFTE category and that partner A is allocated \$65 of gross income, partner B is allocated \$45 of gross income and partner C is allocated \$20 of gross income and \$30 of expenses. In this case, solely for purposes of the safe harbor, partner A's distributive share of income is \$59 ($\$65/\$110 \times \100) and partner B's distributive share of income is \$41 ($\$45/\$110 \times \100).

3. No net income

The final regulations contain a special rule for cases in which CFTEs are allocated and apportioned to a CFTE category that does not have any net income for U.S. tax purposes in the year the foreign taxes are paid or accrued. In such cases, there is no net income in the CFTE category to which the CFTEs relate. In the absence of a special rule, allocations of such CFTEs among the partners would not fall within the general safe harbor of the final regulations and would be required to be allocated in accordance with the partners' interests in the partnership. To eliminate uncertainty in this situation, the final regulations include a rule that relates such CFTEs

to net income recognized for U.S. tax purposes in other years or in other CFTE categories. (For rules relating to the allocation and apportionment of CFTEs to a CFTE category, see section D below.)

Under the final regulations, CFTEs allocated and apportioned to a CFTE category that has no net income for U.S. tax purposes will be deemed to relate to the aggregate net income (if any) recognized by the partnership in that CFTE category during the preceding three-year period (not taking into account years in which there is a net loss in the CFTE category for U.S. tax purposes). Accordingly, the CFTEs in these situations generally must be allocated among the partners in the same proportion as the allocations of such net income for the prior three-year period to satisfy the safe harbor. If the partnership does not have net income in the applicable CFTE category in either the current year or any of the previous three taxable years, the CFTEs must be allocated among the partners in the same proportion that the partnership reasonably expects to allocate net income in the applicable CFTE category over the succeeding three years. If the partnership does not reasonably expect to have net income in the applicable CFTE category in the succeeding three years, the CFTEs must be allocated among the partners in the same proportion as the total partnership net income for the year is allocated. If the CFTE cannot be allocated under any of the foregoing rules, it must be allocated in proportion to the partners' outstanding capital contributions.

D. Allocation and Apportionment of CFTEs to CFTE Categories

The temporary and proposed regulations provided that the income to which a CFTE relates is determined in accordance with the principles of §1.904-6. Section 1.904-6, which contains rules for allocating and apportioning foreign taxes to the categories of income described in section 904(d), provides generally that a foreign tax is related to income if the income is included in the base upon which the foreign tax is imposed. Section 1.904-6(a)(1)(ii) contains special rules for apportioning taxes among categories of income when the income on which the foreign tax is imposed includes income in more than one category. It also provides special rules

for allocating a foreign tax that is imposed on an item that would be income under U.S. tax principles in another year (timing difference) or an item that does not constitute income under U.S. tax principles (base differences).

A number of comments were received requesting clarification of the §1.904-6 principles that apply for purposes of these regulations. In particular, commentators requested guidance concerning the applicability of the related party interest expense rule in §1.904-6(a)(1)(ii), timing and base differences, and inter-branch payments.

The final regulations retain the rule that the determination of the income to which a CFTE relates is made in accordance with the principles of §1.904-6. In response to the comments, however, the final regulations contain several clarifications and modifications regarding how the principles of §1.904-6 apply in allocating foreign taxes to CFTE categories. The final regulations clarify that in applying §1.904-6 for purposes of the safe harbor, the relevant categories are the CFTE categories determined under the rules described in section B in this preamble. Therefore, the final regulations clarify that application of the principles of §1.904-6 requires a CFTE to be allocated to a CFTE category if the net income on which the tax is imposed (the net income recognized for foreign tax purposes) is in the CFTE category. The final regulations also provide guidance on (a) the apportionment rule in §1.904-6(a)(1)(ii), (b) the rules for timing differences, (c) the rules for base differences and (d) the treatment of inter-branch payments.

1. Apportionment of CFTEs

Section 1.904-6(a)(1)(ii) provides that where foreign taxes are imposed on income that relates to more than one separate category, the foreign taxes must be apportioned among the separate categories *pro rata* based on the amount of net income in each category. Subject to a special rule for related party interest expense, the net income in each category generally is determined under foreign law. If foreign law does not provide rules for the allocation and apportionment of expenses, losses or other deductions to a particular category of income, then such items must be allo-

cated and apportioned in accordance with the rules of §§1.861–8 through 1.861–14T.

Commentators requested clarification that the apportionment rule in §1.904–6(a)(1)(ii), which apportions foreign taxes among categories based on relative amounts of net income as determined under foreign law, applies for purposes of apportioning taxes among the categories of income created by the partnership agreement. Commentators recommended that the related party interest expense rule be disregarded for purposes of the apportionment rule.

In response to these comments, the final regulations clarify that the principles of §1.904–6(a)(1)(ii) require a taxpayer to apportion foreign taxes among the CFTE categories based on the relative amounts of net income as determined under foreign law in each CFTE category. In addition, the final regulations modify the apportionment rule in two respects. See §1.704–(b)(4)(viii)(d)(I).

The final regulations adopt the recommendation to disregard the related party interest expense rule contained in §1.904–6(a)(1)(ii) for purposes of apportioning taxes among the CFTE categories on the basis of foreign net income. The IRS and the Treasury Department agree that this rule, which coordinates the characterization of taxes and income for section 904(d) purposes, is not relevant for purposes of apportioning CFTEs to CFTE categories. Rather, the apportionment of CFTEs is based on the partnership income, as determined under foreign law, in the CFTE categories, which may include partnership items in one or more section 904(d) categories.

The final regulations also provide that if foreign law does not provide rules for the allocation and apportionment of expenses, losses or other deductions allowed under foreign law to a CFTE category of income, then such expenses, losses or other deductions must be allocated and apportioned to gross income as determined under foreign law in a manner that is consistent with the allocation and apportionment of such items for purposes of determining the net income in the CFTE category for U.S. tax purposes.

2. *Timing differences*

A timing difference arises when an item subject to foreign tax is recognized as income under U.S. tax principles in a different year. The temporary and proposed regulations did not contain a specific textual rule regarding the application of the timing difference rule of §1.904–6(a)(1)(iv) in the context of section 704(b). However, the temporary and proposed regulations included an example that involved a timing difference (Example 27), which indicated that a current year CFTE attributable to an item of income recognized in the prior year for U.S. tax purposes related to, and thus must be allocated in accordance with, the income allocated under the partnership agreement in the prior year.

Upon further consideration, the IRS and the Treasury Department have concluded that relating foreign taxes paid or accrued in one year to income recognized for U.S. tax purposes in another year would be difficult for taxpayers to comply with and for the IRS to administer. In many instances, it would be difficult to identify accurately the extent of timing differences and the years in which such differences would be reversed. Moreover, where income allocations change from year to year, it often would be impossible for partnerships to determine how the partners would share related U.S. income in subsequent years. Accordingly, the final regulations provide for a more administrable rule that requires the partnership to allocate a CFTE attributable to a timing difference among the partners in the same proportions as the allocations of income recognized for U.S. tax purposes in the relevant CFTE category in the year such taxes are paid or accrued. See paragraph (b)(5) *Example 23* (reflecting modifications to *Example 27* in the temporary and proposed regulations). This approach should result in allocations of CFTEs that are generally in proportion to the partners' distributive shares of U.S. taxable income over time, and therefore is consistent with the underlying purposes of the foreign tax credit rules to mitigate double taxation. See the discussion at section E in this preamble under "Partners' Interests in the Partnership" for cases in which the partnership agreement allocates CFTEs attributable to a timing difference among the partners in proportion to allocations of U.S. income in an earlier or

later year when the income with respect to which the foreign tax is imposed is recognized for U.S. tax purposes.

In addition, the final regulations expressly incorporate the timing difference rule of §1.904–6(a)(1)(iv). Therefore, a CFTE attributable to a timing difference is allocated to the CFTE category to which the income would be assigned if the income were recognized for U.S. tax purposes in the year in which the foreign tax is imposed.

3. *Base differences*

A base difference arises when an item subject to foreign tax is not income under U.S. tax principles. Several commentators observed that the base difference rule under §1.904–6(a)(1)(iv) provides little indication of how a CFTE attributable to a base difference should be allocated for purposes of the safe harbor. The IRS and the Treasury Department agree that this issue should be clarified. In the absence of any income to which such a CFTE relates, the final regulations provide that a CFTE attributable to a base difference is related to the income recognized for U.S. tax purposes in the relevant CFTE category in the year such taxes are paid or accrued. For this purpose, a CFTE attributable to a base difference is allocated and apportioned to the CFTE category that includes the partnership items attributable to the activity with respect to which the creditable foreign tax is imposed. Thus, the final regulations adopt similar rules for dealing with timing and base differences. These changes are intended to provide greater certainty for taxpayers and simplify the administration of the safe harbor.

4. *Inter-branch transactions*

Several commentators requested additional guidance regarding the application of the final regulations to transactions between branches (including disregarded entities owned by the partnership) that are disregarded for U.S. tax purposes. In response to this comment, the final regulations provide that if a branch of the partnership (including a disregarded entity owned by the partnership) is required to include in income under foreign law a payment (inter-branch payment) it receives from the partnership or another branch of the partnership, any CFTE imposed with respect

to the payment relates to the income in the CFTE category that includes the items attributable to the recipient. In cases where the partnership agreement results in more than one CFTE category with respect to the recipient, such tax is allocated to the CFTE category that includes the items attributable to the activity to which the inter-branch payment relates. A similar rule applies to payments received by the partnership from a branch of the partnership. This rule is consistent with the timing and base difference rules in the final regulations because it associates foreign tax imposed on the recipient with net income of the recipient as determined under U.S. tax principles, notwithstanding differences in U.S. and foreign tax rules. Like the timing and base difference rules, this rule avoids the need for complex tracing rules.

It is possible that this approach might result in distortions of the effective foreign tax rates on the partners' distributive shares of income in certain cases. Nevertheless, the IRS and the Treasury Department have concluded that imposing a requirement to trace taxes imposed on the recipient with respect to such inter-branch payments to income recognized under U.S. tax principles by the payor would be difficult for taxpayers to comply with and for the IRS to administer.

Some commentators recommended that at least in cases where the income allocations take such inter-branch payments into account in determining the partners' distributive shares of income, the allocation of CFTEs should be respected if made in proportion to income allocations that reflect such payments. The final regulations do not adopt this comment, as the approach suggested by these commentators would require taxpayers and the IRS to identify the inter-branch payments and relate such amounts to items of income of the payor and to CFTEs imposed on the recipient to substantiate that CFTEs of the payor and recipient were properly allocated. The IRS and the Treasury Department concluded that this approach would be difficult to administer and was therefore ill-suited to inclusion in a safe harbor. See the discussion at section E under "Partners' Interests in the Partnership" for cases in which the partnership agreement allocates partnership items of income to reflect inter-branch payments.

E. *Partners' Interests in the Partnership*

Some commentators suggested that allocations of CFTEs that are not proportionate to allocations of the related income (and therefore fail to satisfy the safe harbor) will nevertheless be valid as in accordance with the partners' interests in the partnership standard of §1.704-1(b)(3). According to these commentators, the partners' interests in the partnership with respect to a CFTE are conclusively determined by the manner in which the CFTE is allocated under the partnership agreement. The IRS and the Treasury Department believe that this view of the partners' interests in the partnership is incorrect, particularly in the context of a CFTE that is allocated to a partner who can use the associated foreign tax credit. In such a situation, the partner is relieved of a corresponding amount of U.S. tax, and thus does not bear the economic burden of the CFTE. Because of this lack of economic burden, the allocation of the CFTE is meaningless in the determination of the partners' interests in the partnership with respect to the CFTE and with respect to any other partnership item that has a material effect on the amount of CFTE that would be allocated to a partner under the safe harbor of the final regulations. Consequently, the final regulations clarify that in determining the partners' interests in the partnership with respect to an allocation of a partnership item, the allocation of the CFTE itself must be disregarded. This rule does not apply where the partners to whom the taxes are allocated reasonably expect to claim a deduction for such taxes in determining their U.S. tax liabilities.

As indicated in the preamble to the temporary regulations, the IRS and the Treasury Department believe that only in unusual circumstances (such as where the CFTEs are deducted and not credited) will allocations that fail to satisfy the safe harbor be in accordance with the partners' interests in the partnership. As discussed in this preamble, for administrative reasons, the final regulations do not adopt a tracing approach for timing differences or inter-branch payments. Allocations of foreign taxes in such situations that are based on a tracing approach may constitute an unusual situation where the safe harbor is not satisfied, but the allocations are in ac-

cordance with the partners' interests in the partnership.

When a CFTE is attributable to a timing difference, the CFTE category to which the CFTE is allocated may or may not have income for U.S. tax purposes in the year the foreign tax is paid or accrued. In either case, allocations of such CFTEs that are proportionate to allocations of the income at the time such income is recognized for U.S. tax purposes may not qualify for safe harbor treatment, but nonetheless be in accordance with the partners' interests in the partnership.

Allocations of CFTEs imposed on the payor of an inter-branch payment may fail the safe harbor, but nonetheless be in accordance with the partners' interests in the partnership if the allocations of the CFTEs are in the same proportions as the allocations of the income of the payor, other than income that is eliminated from the foreign tax base because the inter-branch payment is deductible under foreign law. See paragraph (b)(5) *Example 24* (iv). Similarly, allocations of CFTEs imposed on the recipient with respect to an inter-branch payment may fail the safe harbor, but nonetheless be in accordance with the partners' interests in the partnership, if such allocations are proportionate to the allocations of income recognized for U.S. tax purposes out of which the payment is made. See paragraph (b)(5) *Example 24* (iii).

Several commentators also requested guidance regarding whether a reallocation of CFTEs will cause the IRS to reallocate other partnership items so that the partners' ending capital account balances will remain unchanged. If the reallocation of the CFTEs causes the partners' capital accounts not to reflect their contemplated economic arrangement, the partners may need to reallocate other partnership items to ensure the tax consequences of the partnership allocations are consistent with their contemplated economic arrangement. Consistent with the principles of the proposed and temporary regulations, the final regulations clarify that the IRS generally will not reallocate other partnership items in the year in which a CFTE is reallocated. See paragraph (b)(5) *Example 25* (ii). This treatment is also consistent with the results arising from an approach taken with respect to reallocations of other items of income, gain, loss or deduction that are not sustained under section 704(b).

The IRS and the Treasury Department believe the parties and not the government should determine what allocations should be changed to reflect their economic arrangement.

F. Effective Date and Transition Rule

The provisions of these final regulations generally apply for partnership taxable years beginning on or after October 19, 2006. A transition rule is provided for existing partnerships. Under the transition rule, if a partnership agreement was entered into before April 21, 2004, then the partnership may apply the provisions of §1.704-1(b) as if the amendments made by these final regulations had not occurred. If the partnership agreement is materially modified on or after April 21, 2004, however, transition relief is no longer afforded, and the rules of §1.704-1T(b)(4)(xi) or these final regulations apply, depending upon the date on which the material modification occurs and the tax year at issue. For this purpose, a material modification includes any change in ownership of the partnership. This transition rule does not apply if, as of April 20, 2004, persons that are related to each other (within the meaning of sections 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party. However, taxpayers may rely on the provisions of paragraph (b)(4)(viii) of this section for partnership taxable years beginning on or after April 21, 2004.

As stated in this preamble, the temporary and proposed regulations included a limited transition relief provision which ceases to apply upon a material modification of the partnership agreement, including any change in ownership. In addition, transition relief was not provided to partnerships owned by related parties who collectively have the power to amend the partnership agreement. One commentator requested that the IRS and the Treasury Department consider modifying the transition relief provision to indicate that a change in ownership is not a material modification unless there is more than a 50 percent change in ultimate beneficial ownership over a three-year period. The commentator also requested that the final regulations include a rule providing transition relief to partnerships owned by related par-

ties who collectively have the power to amend the partnership agreement only in a way that does not adversely impact unrelated partners.

After careful consideration of these comments, the IRS and the Treasury Department have decided not to expand the transition relief described in the proposed and temporary regulations. Accordingly, the final regulations do not adopt these comments.

G. Other Comments

One commentator suggested that where the partners are unrelated, the safe harbor should permit the partnership to allocate CFTEs in the same proportion as all other partnership expenses (rather than in proportion to related income). Section 1.704-1(b)(4)(ii) requires partnership credits to be allocated in the same proportions as items giving rise to the credits. Allocating CFTEs in proportion to other partnership expenses would be inconsistent with §1.704-1(b)(4)(ii). Moreover, such an approach would result in the inappropriate separation of CFTEs from the income to which such CFTEs relate. Thus, the final regulations do not incorporate this comment.

The temporary and proposed regulations provided that the safe harbor is available if the partnership agreement satisfied the requirements of §1.704-1(b)(2)(ii)(b) or (d) (capital account maintenance, liquidation according to capital accounts, and either deficit restoration obligation or qualified income offsets) and the partnership agreement provided for the allocation of the CFTE in proportion to the partner's distributive share of partnership income. Commentators suggested that the safe harbor also should be available if the partnership allocations satisfy the economic effect equivalence standard of §1.704-1(b)(2)(ii)(i).

The purpose of the safe harbor is to provide assurance that allocations of CFTEs will be respected if the CFTEs are allocated in proportion to the income to which such CFTEs relate. This purpose is satisfied as long as CFTEs are allocated in proportion to valid allocations of net income, regardless of whether the partnership maintains capital accounts or liquidates in accordance with them. Accordingly, the final regulations adopt these

comments by eliminating the requirement that the partnership allocations satisfy the requirements of §1.704-1(b)(2)(ii)(b) or (d), and instead condition eligibility for the safe harbor on the validity of income allocations, as described in this preamble.

One commentator suggested that the final regulations clarify that the underlying allocation of income to which the foreign tax relates itself must be valid in order to qualify for the safe harbor. The commentator pointed out that an income allocation may be valid because it has substantial economic effect, or because it is in accordance with (or is deemed to be in accordance with) the partners' interests in the partnership. If income allocations are not valid, allocations of CFTEs based on such allocations will not be in proportion to the income to which the CFTEs relate. Accordingly, it is appropriate to clarify that the allocations of other items must be valid. However, the IRS and the Treasury Department believe that invalid allocations of other items should not disqualify allocations of CFTEs for safe harbor treatment unless the invalid allocations, in the aggregate, materially affect the allocation of CFTEs. Therefore, the final regulations provide that allocations of CFTEs may qualify for safe harbor treatment so long as allocations of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs allocated to the partners are valid.

Commentators suggested that the safe harbor should be available if the partnership agreement is silent with regard to the allocation of CFTEs, but actual allocations of CFTEs are made in proportion to related income. The IRS and the Treasury Department agree. Accordingly, the final regulations allow safe harbor treatment if the CFTE is allocated (whether or not pursuant to an express provision in the partnership agreement) and reported on the partnership return in proportion to the distributive shares of income to which the CFTE relates.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Admin-

istrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of rulemaking preceding 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 authors of this regulation are Timothy J. Leska, Office of the Associate Chief Counsel (Passthroughs & Special Industries) and Michael I. Gilman, Of-

fice of the Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its 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 1.704-1 is amended as follows:

1. Paragraph (b)(0) is amended by redesignating the entry in the table of

contents for §1.704-1(b)(4)(xi) as the entry for §1.704-1(b)(4)(viii) and by adding entries following the entry for §1.704-1(b)(4)(viii). The entries for §§1.704-1(b)(4)(ix) and 1.704-1(b)(4)(x) are removed.

2. The heading and text of paragraphs (b)(1)(ii)(b) and (b)(5) *Examples* 25 through 28 are revised.

3. Paragraphs (b)(3)(iv), (b)(4)(viii) and (b)(5) *Examples* 20 through 24 are added.

4. Paragraph (b)(4)(xi) is removed.

The additions and revisions read as follows:

§1.704-1 *Partner's distributive share.*

* * * * *

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

Heading	Section
* * * * *	
Allocation of creditable foreign taxes	1.704-1(b)(4)(viii)
In general	1.704-1(b)(4)(viii)(a)
Creditable foreign tax expenditures (CFTEs)	1.704-1(b)(4)(viii)(b)
Income to which CFTEs relate	1.704-1(b)(4)(viii)(c)
In general	1.704-1(b)(4)(viii)(c)(1)
CFTE category	1.704-1(b)(4)(viii)(c)(2)
Net income in a CFTE category	1.704-1(b)(4)(viii)(c)(3)
Distributive shares of income	1.704-1(b)(4)(viii)(c)(4)
No net income in a CFTE category	1.704-1(b)(4)(viii)(c)(5)
Allocation and apportionment of CFTEs to CFTE categories	1.704-1(b)(4)(viii)(d)
In general	1.704-1(b)(4)(viii)(d)(1)
Timing and base differences	1.704-1(b)(4)(viii)(d)(2)
Special rules for inter-branch payments	1.704-1(b)(4)(viii)(d)(3)

* * * * *

(1) * * *

(ii) * * *

(b) *Rules relating to foreign tax expenditures—(1) In general.* The provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section (regarding the allocation of creditable foreign taxes) apply for partnership taxable years beginning on or after October 19, 2006. The rules that apply to allocations of creditable foreign taxes made in partnership taxable years beginning before October 19, 2006 are contained in §§1.704-1T(b)(1)(ii)(b)(1) and 1.704-1T(b)(4)(xi) as in effect prior to October 19, 2006 (see 26 CFR part 1 revised as of April 1, 2005). However, taxpayers may rely on the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section for

partnership taxable years beginning on or after April 21, 2004.

(2) *Transition rule.* Transition relief is provided herein to partnerships whose agreements were entered into prior to April 21, 2004. In such case, if there has been no material modification to the partnership agreement on or after April 21, 2004, then the partnership may apply the provisions of paragraph (b) of this section as if the amendments made by paragraphs (b)(3)(iv) and (b)(4)(viii) of this section had not occurred. If the partnership agreement was materially modified on or after April 21, 2004, then the rules provided in paragraphs (b)(3)(iv) and (b)(4)(viii) of this section shall apply to the later of the taxable year beginning on or after October 19, 2006, or the taxable year within which

the material modification occurred, and to all subsequent taxable years. If the partnership agreement was materially modified on or after April 21, 2004, and before a tax year beginning on or after October 19, 2006, see §§1.704-1T(b)(1)(ii)(b)(1) and 1.704-1T(b)(4)(xi) as in effect prior to October 19, 2006 (26 CFR part 1 revised as of April 1, 2005). For purposes of this paragraph (b)(1)(ii)(b)(2), any change in ownership constitutes a material modification to the partnership agreement. This transition rule does not apply to any taxable year (and all subsequent taxable years) in which persons that are related to each other (within the meaning of section 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party.

* * * * *

(3) * * *

(iv) *Special rule for creditable foreign tax expenditures.* In determining whether an allocation of a partnership item is in accordance with the partners' interests in the partnership, the allocation of the creditable foreign tax expenditure (CFTE) (as defined in paragraph (b)(4)(viii)(b) of this section) must be disregarded. This paragraph (b)(3)(iv) shall not apply to the extent the partners to whom such taxes are allocated reasonably expect to claim a deduction for such taxes in determining their U.S. tax liabilities.

(4) * * *

(viii) *Allocation of creditable foreign taxes—(a) In general.* Allocations of creditable foreign taxes do not have substantial economic effect within the meaning of paragraph (b)(2) of this section and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership. See paragraph (b)(3)(iv) of this section. An allocation of a creditable foreign tax expenditure (CFTE) will be deemed to be in accordance with the partners' interests in the partnership if—

(1) The CFTE is allocated (whether or not pursuant to an express provision in the partnership agreement) and reported on the partnership return in proportion to the distributive shares of income to which the CFTE relates; and

(2) Allocations of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs allocated to a partner pursuant to paragraph (b)(4)(viii)(a)(1) of this section are valid.

(b) *Creditable foreign tax expenditures (CFTEs).* For purposes of this section, a CFTE is a foreign tax paid or accrued by a partnership that is eligible for a credit under section 901(a) or an applicable U.S. income tax treaty. A foreign tax is a CFTE for these purposes without regard to whether a partner receiving an allocation of such foreign tax elects to claim a credit for such tax. Foreign taxes paid or accrued by a partner with respect to a distributive share of partnership income, and foreign taxes deemed paid under section 902 or 960 by a corporate partner with respect to stock owned, directly or indirectly, by or for a partnership, are not taxes paid or accrued by a partnership and, therefore, are not CFTEs subject to the rules of this

section. See paragraphs (e) and (f) of §1.901-2 for rules for determining when and by whom a foreign tax is paid or accrued.

(c) *Income to which CFTEs relate—(1) In general.* For purposes of paragraph (b)(4)(viii)(a) of this section, CFTEs are related to net income in the partnership's CFTE category or categories to which the CFTE is allocated and apportioned in accordance with the rules of paragraph (b)(4)(viii)(d) of this section. Paragraph (b)(4)(viii)(c)(2) of this section provides rules for determining a partnership's CFTE categories. Paragraph (b)(4)(viii)(c)(3) of this section provides rules for determining the net income in each CFTE category. Paragraph (b)(4)(viii)(c)(4) of this section provides guidance in determining a partner's distributive share of income in a CFTE category. Paragraph (b)(4)(viii)(c)(5) of this section provides a special rule for allocating CFTEs when a partnership has no net income in a CFTE category.

(2) *CFTE category—(i) Income from activities.* A CFTE category is a category of net income (or loss) attributable to one or more activities of the partnership. Net income (or loss) from all the partnership's activities shall be included in a single CFTE category unless the allocation of net income (or loss) from one or more activities differs from the allocation of net income (or loss) from other activities, in which case income from each activity or group of activities that is subject to a different allocation shall be treated as net income (or loss) in a separate CFTE category.

(ii) *Different allocations.* Different allocations of net income (or loss) generally will result from provisions of the partnership agreement providing for different sharing ratios for net income (or loss) from separate activities. Different allocations of net income (or loss) from separate activities generally will also result if any partnership item is shared in a different ratio than any other partnership item. A guaranteed payment described in paragraph (b)(4)(viii)(c)(3)(ii) of this section, gross income allocation, or other preferential allocation will result in different allocations of net income (or loss) from separate activities only if the amount of the payment or the allocation is determined by reference to income from less than all

of the partnership's activities. For purposes of this paragraph (b)(4)(viii)(c)(2), a partnership item shall not include any item that is excluded from income attributable to an activity pursuant to the second sentence of paragraph (b)(4)(viii)(c)(3)(ii) of this section (relating to allocations or payments that result in a deduction under foreign law).

(iii) *Activity.* Whether a partnership has one or more activities, and the scope of each activity, shall be determined in a reasonable manner taking into account all the facts and circumstances. In evaluating whether aggregating or disaggregating income from particular business or investment operations constitutes a reasonable method of determining the scope of an activity, the principal consideration is whether the proposed determination has the effect of separating CFTEs from the related foreign income. Accordingly, relevant considerations include whether the partnership conducts business in more than one geographic location or through more than one entity or branch, and whether certain types of income are exempt from foreign tax or subject to preferential foreign tax treatment. In addition, income from a divisible part of a single activity shall be treated as income from a separate activity if necessary to prevent separating CFTEs from the related foreign income. The partnership's activities must be determined consistently from year to year absent a material change in facts and circumstances.

(3) *Net income in a CFTE category—(i) In general.* The net income in a CFTE category means the net income for U.S. Federal income tax purposes, determined by taking into account all partnership items attributable to the relevant activity or group of activities, including items of gross income, gain, loss, deduction, and expense and items allocated pursuant to section 704(c). The items of gross income attributable to an activity shall be determined in a consistent manner under any reasonable method taking into account all the facts and circumstances. Except as otherwise provided below, expenses, losses or other deductions shall be allocated and apportioned to gross income attributable to an activity in accordance with the rules of §§1.861-8 and 1.861-8T. Under these rules, if an expense, loss or other deduction is allocated to gross income from

more than one activity, such expense, loss or deduction must be apportioned among each such activity using a reasonable method that reflects to a reasonably close extent the factual relationship between the deduction and the gross income from such activities. See §1.861-8T(c). For purposes of determining net income in a CFTE category, the partnership's interest expense and research and experimental expenditures described in section 174 may be allocated and apportioned under any reasonable method, including but not limited to the methods prescribed in §1.861-9 through §1.861-13T (interest expense) and §1.861-17 (research and experimental expenditures). For purposes of determining the net income attributable to any activity of a branch, the only items of gross income taken into account in applying this paragraph (b)(4)(viii)(c)(3) are those items of gross income recognized by the branch for U.S. income tax purposes. See paragraph (b)(5) *Example 24* of this section (relating to inter-branch payments).

(ii) *Special rules.* Income attributable to an activity shall include the amount included in a partner's income as a guaranteed payment (within the meaning of section 707(c)) from the partnership to the extent that the guaranteed payment is not deductible by the partnership under foreign law. See paragraph (b)(5) *Example 25* (iv) of this section. Except for an inter-branch payment described in paragraph (b)(4)(viii)(d)(3) of this section, income attributable to an activity shall not include an item of partnership income to the extent the allocation of such item of income (or payment thereof) results in a deduction under foreign law. See paragraph (b)(5) *Example 25* (iii) and (iv) of this section. Similarly, income attributable to an activity shall not include net income that foreign law would exclude from the foreign tax base as a result of the status of a partner. See paragraph (b)(5) *Example 27* of this section.

(4) *Distributive shares of income.* For purposes of paragraph (b)(4)(viii)(a)(I) of this section, distributive share of income means the net income from each CFTE category, determined in accordance with paragraph (b)(4)(viii)(c)(3) of this section, that is allocated to a partner. A guaranteed payment shall be treated as a distributive share of income for purposes of paragraph (b)(4)(viii)(a)(I) of this section to the ex-

tent that the guaranteed payment is treated as income attributable to an activity pursuant to paragraph (b)(4)(viii)(c)(3)(ii) of this section. See paragraph (b)(5) *Example 25* (iv) of this section. If more than one partner receives positive income allocations (income in excess of expenses) from a CFTE category, which in the aggregate exceed the total net income in the CFTE category, then for purposes of paragraph (b)(4)(viii)(a)(I) of this section such partner's distributive share of income from the CFTE category shall equal the partner's positive income allocation from the CFTE category, divided by the aggregate positive income allocations from the CFTE category, multiplied by the net income in the CFTE category.

(5) *No net income in a CFTE category.* If a CFTE is allocated or apportioned to a CFTE category that does not have net income for the year in which the foreign tax is paid or accrued, the CFTE shall be deemed to relate to the aggregate of the net income (disregarding net losses) recognized by the partnership in that CFTE category in each of the three preceding taxable years. Accordingly, except as provided below, such CFTE must be allocated in the current taxable year in the same proportion as the allocation of the aggregate net income for the prior three-year period in order to satisfy the requirements of paragraph (b)(4)(viii)(a)(I) of this section. If the partnership does not have net income in the applicable CFTE category in either the current year or any of the previous three taxable years, the CFTE must be allocated in the same proportion that the partnership reasonably expects to allocate the aggregate net income (disregarding net losses) in the CFTE category for the succeeding three taxable years. If the partnership does not reasonably expect to have net income in the CFTE category for the succeeding three years and the partnership has net income in one or more other CFTE categories for the year in which the foreign tax is paid or accrued, the CFTE shall be deemed to relate to such other net income and must be allocated in proportion to the allocations of such other net income. If any CFTE is not allocated pursuant to the above provisions of this paragraph then the CFTE must be allocated in proportion to the partners' outstanding capital contribu-

(d) *Allocation and apportionment of CFTEs to CFTE categories—(1) In general.* CFTEs are allocated and apportioned to CFTE categories in accordance with the principles of §1.904-6. Under these principles, a CFTE is related to income in a CFTE category if the income is included in the base upon which the foreign tax is imposed. In accordance with §1.904-6(a)(1)(ii) as modified by this paragraph (b)(4)(viii)(d), if the foreign tax base includes income in more than one CFTE category, the CFTEs are apportioned among the CFTE categories based on the relative amounts of taxable income computed under foreign law in each CFTE category. For purposes of this paragraph (b)(4)(viii)(d), references in §1.904-6 to a separate category or separate categories shall mean "CFTE category" or "CFTE categories" and the rules in §1.904-6(a)(1)(ii) are modified as follows:

(i) The related party interest expense rule in §1.904-6(a)(1)(ii) shall not apply in determining the amount of taxable income computed under foreign law in a CFTE category.

(ii) If foreign law does not provide for the direct allocation or apportionment of expenses, losses or other deductions allowed under foreign law to a CFTE category of income, then such expenses, losses or other deductions must be allocated and apportioned to gross income as determined under foreign law in a manner that is consistent with the allocation and apportionment of such items for purposes of determining the net income in the CFTE categories for U.S. tax purposes pursuant to paragraph (b)(4)(viii)(c)(3) of this section.

(2) *Timing and base differences.* A foreign tax imposed on an item that would be income under U.S. tax principles in another year (a timing difference) is allocated to the CFTE category that would include the income if the income were recognized for U.S. tax purposes in the year in which the foreign tax is imposed. A foreign tax imposed on an item that would not constitute income under U.S. tax principles in any year (a base difference) is allocated to the CFTE category that includes the partnership items attributable to the activity with respect to which the foreign tax is imposed. See paragraph (b)(5) *Example 23* of this section.

(3) *Special rules for inter-branch payments.* Notwithstanding any other provision of this paragraph (d), the rules of this paragraph (b)(4)(viii)(d)(3) shall apply if a branch (including an entity described in §301.7701-2(c)(2)(i) of this chapter) of the partnership is required to include in income under foreign law a payment it receives from another branch of the partnership. The foreign tax imposed on such payments (“inter-branch payments”) is allocated to the CFTE category that includes the items attributable to the relevant activities of the recipient branch. In cases where the partnership agreement results in more than one CFTE category with respect to activities of the recipient branch, such tax is allocated to the CFTE category that includes the items attributable to the activity to which the inter-branch payment relates. The rules of this paragraph (b)(4)(viii)(d)(3) shall also apply to payments between a partnership and a branch of the partnership. See paragraph (b)(5) *Example 24* of this section.

* * *

(xi) [Reserved].

(5) * * *

Example 20. (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and earns income from passive investments in country X. Country X imposes a 40 percent tax on business M income, which tax is a CFTE, but exempts from tax income from passive investments. In 2007, AB earns \$100,000 of income from business M and \$30,000 from passive investments and pays or accrues \$40,000 of country X taxes. For purposes of section 904(d), the income from business M is general limitation income and the income from the passive investments is passive income. Pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 60 percent to A and 40 percent to B, and all partnership items, including CFTEs, from passive investments are allocated 80 percent to A and 20 percent to B. Accordingly, A is allocated 60 percent of the business M income (\$60,000) and 60 percent of the country X taxes (\$24,000), and B is allocated 40 percent of the business M income (\$40,000) and 40 percent of the country X taxes (\$16,000). The income from the passive investments is allocated \$24,000 to A and \$6,000 to B. Assume that allocations of all items other than CFTEs are valid.

(ii) Because the partnership agreement provides for different allocations of the net income attributable to business M and the passive investments, the net income attributable to each is income in a separate CFTE category. See paragraph (b)(4)(viii)(c)(2) of this section. AB must determine the net income in each CFTE category and the CFTEs allocable to each CFTE category. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the business M CFTE

category is the \$100,000 attributable to business M and the net income in the passive investments CFTE category is the \$30,000 attributable to the passive investments. Under paragraph (b)(4)(viii)(d) of this section, the \$40,000 of country X taxes is allocated to the business M CFTE category and no portion of the country X taxes is allocated to the passive investments CFTE category. Therefore, the \$40,000 of country X taxes are related to the \$100,000 of net income in the business M CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB’s partnership agreement allocates the net income from the business M CFTE category 60 percent to A and 40 percent to B, and the country X taxes 60 percent to A and 40 percent to B, the allocations of the CFTEs are in proportion to the distributive shares of income to which the CFTEs relate. Because AB satisfies the requirement of paragraph (b)(4)(viii) of this section, the allocations of the country X taxes are deemed to be in accordance with the partners’ interests in the partnership. Because the business M income is general limitation income, all \$40,000 of taxes are attributable to the general limitation category. See §1.904-6.

Example 21. (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and business N in country Y. Country X imposes a 40 percent tax on business M income, country Y imposes a 20 percent tax on business N income, and the country X and country Y taxes are CFTEs. In 2007, AB has \$100,000 of income from business M and \$50,000 of income from business N. Country X imposes \$40,000 of tax on the income from business M and country Y imposes \$10,000 of tax on the income of business N. Pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 75 percent to A and 25 percent to B, and all partnership items, including CFTEs, from business N are split evenly between A and B (50 percent each). Accordingly, A is allocated 75 percent of the income from business M (\$75,000), 75 percent of the country X taxes (\$30,000), 50 percent of the income from business N (\$25,000), and 50 percent of the country Y taxes (\$5,000). B is allocated 25 percent of the income from business M (\$25,000), 25 percent of the country X taxes (\$10,000), 50 percent of the income from business N (\$25,000), and 50 percent of the country Y taxes (\$5,000). Assume that allocations of all items other than CFTEs are valid. The income from business M and business N is general limitation income for purposes of section 904(d).

(ii) Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each business is income in a separate CFTE category even though all of the income is in the general limitation category for section 904(d) purposes. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the business M CFTE category is the \$100,000 attributable to business M and the net income in the business N CFTE category is \$50,000 attributable to business N. Under paragraph (b)(4)(viii)(d) of this section, the \$40,000 of country X taxes is allocated to the business M CFTE category and the \$10,000 of country Y taxes is allocated to the business N CFTE category. Therefore, the \$40,000 of country X taxes are related to the \$100,000 of net income in the busi-

ness M CFTE category and the \$10,000 of country Y taxes are related to the \$50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB’s partnership agreement allocates the \$40,000 of country X taxes in the same proportion as the net income in the business M CFTE category, and the \$10,000 of country Y taxes in the same proportion as the net income in the business N CFTE category, the allocations of the country X taxes and the country Y taxes are in proportion to the distributive shares of income to which the foreign taxes relate. Because AB satisfies the requirements of paragraph (b)(4)(viii) of this section, the allocations of the country X and country Y taxes are deemed to be in accordance with the partners’ interests in the partnership.

Example 22. (i) The facts are the same as in *Example 21*, except that the partnership agreement provides for the following allocations. Depreciation attributable to machine X, which is used in business M, is allocated 100 percent to A. B is allocated the first \$20,000 of gross income attributable to business N, which allocation does not result in a deduction under foreign law. All remaining items, except CFTEs, are allocated 50 percent to A and 50 percent to B. For 2007, assume that business M generates \$120,000 of income, before taking into account depreciation attributable to machine X. The total amount of depreciation attributable to machine X is \$20,000, which results in \$100,000 of net income attributable to business M for U.S. and country X tax purposes. Business N generates \$70,000 of gross income and has \$20,000 of expenses, resulting in \$50,000 of net income for U.S. and country Y tax purposes. Pursuant to the partnership agreement, A is allocated \$40,000 of the net income attributable to business M (\$60,000 of business M income less \$20,000 of depreciation attributable to machine X), and \$15,000 of the net income attributable to business N. B is allocated \$60,000 of the net income attributable to business M and \$35,000 of the net income attributable to business N (\$20,000 of gross income, plus \$15,000 of net income).

(ii) As a result of the special allocations, the net income attributable to business M (\$100,000) is allocated 40 percent to A and 60 percent to B. The net income attributable to business N (\$50,000) is allocated 30 percent to A and 70 percent to B. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income from each of businesses M and N is income in a separate CFTE category. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the business M CFTE category is the \$100,000 of net income attributable to business M and the net income in the business N CFTE category is the \$50,000 of net income attributable to business N. Under paragraph (b)(4)(viii)(d)(1) of this section, the \$40,000 of country X taxes is allocated to the business M CFTE category and the \$10,000 of country Y taxes is allocated to the business N CFTE category. Therefore, the \$40,000 of country X taxes relates to the \$100,000 of net income in the business M CFTE and the \$10,000 of country Y taxes relates to the \$50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. The allocations of the country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the

partners' interests in the partnership if such taxes are allocated 40 percent to A and 60 percent to B. The allocations of the country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 30 percent to A and 70 percent to B.

(iii) Assume that for 2008, all the facts are the same as in paragraph (i) of this *Example 22*, except that business M generates \$60,000 of income before taking into account depreciation attributable to machine X and country X imposes \$16,000 of tax on the \$40,000 of net income attributable to business M. Pursuant to the partnership agreement, A is allocated 25 percent of the income from business M (\$10,000), and B is allocated 75 percent of the income from business M (\$30,000). Allocations of the country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 25 percent to A and 75 percent to B.

Example 23. (i) The facts are the same as in *Example 21*, except that AB does not actually receive the \$50,000 of income accrued in 2007 with respect to business N until 2008 and AB accrues and receives an additional \$100,000 with respect to business N in 2008. Also assume that A, B, and AB each report taxable income on an accrual basis for U.S. tax purposes and AB reports taxable income using the cash receipts and disbursements method of accounting for country X and country Y purposes. In 2007, AB pays or accrues country X taxes of \$40,000. In 2008, AB pays or accrues country Y taxes of \$30,000. Pursuant to the partnership agreement, in 2007, A is allocated 75 percent of business M income (\$75,000) and country X taxes (\$30,000) and 50 percent of business N income (\$25,000). B is allocated 25 percent of business M income (\$25,000) and country X taxes (\$10,000) and 50 percent of business N income (\$25,000). In 2008, A and B are each allocated 50 percent of the business N income (\$50,000) and country Y taxes (\$15,000).

(ii) For 2007, the \$40,000 of country X taxes paid or accrued by AB relates to the \$100,000 of net income in the business M CFTE category. No portion of the country X taxes paid or accrued in 2007 relates to the \$50,000 of net income in the business N CFTE category. For 2008, the net income in the business N CFTE category is the \$100,000 attributable to business N. See paragraph (b)(4)(viii)(c)(3) of this section. Under paragraph (b)(4)(viii)(d)(1) of this section, \$20,000 of the country Y tax paid or accrued in 2008 is allocated to the business N CFTE category. The remaining \$10,000 of country Y tax is allocated to the business N CFTE category under paragraph (b)(4)(viii)(d)(2) of this section (relating to timing differences). Therefore, the \$30,000 of country Y taxes paid or accrued by AB in 2008 is related to the \$100,000 of net income in the business N CFTE category for 2008. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the \$40,000 of country X taxes and the \$30,000 of country Y taxes in proportion to the distributive shares of income to which the taxes relate, the allocations of the country X and country Y taxes satisfy the requirements of paragraphs (b)(4)(viii)(a)(1) and (2) of this section and the allocations of the country X and Y taxes are deemed to be in accordance with the

partners' interests in the partnership under paragraph (b)(4)(viii) of this section.

Example 24. (i) The facts are the same as in *Example 21*, except that businesses M and N are conducted by entities (DE1 and DE2, respectively) that are corporations for country X and Y tax purposes and disregarded entities for U.S. tax purposes. Also, assume that DE1 makes payments of \$75,000 during 2007 to DE2 that are deductible by DE1 for country X tax purposes and includible in income of DE2 for country Y tax purposes. As a result of such payments, DE1 has taxable income of \$25,000 for country X purposes on which \$10,000 of taxes are imposed and DE2 has taxable income of \$125,000 for country Y purposes on which \$25,000 of taxes are imposed. For U.S. tax purposes, \$100,000 of AB's income is attributable to the activities of DE1 and \$50,000 of AB's income is attributable to the activities of DE2. Pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 75 percent to A and 25 percent to B, and all partnership items, including CFTEs, from business N are split evenly between A and B (50 percent each). Accordingly, A is allocated 75 percent of the income from business M (\$75,000), 75 percent of the country X taxes (\$7,500), 50 percent of the income from business N (\$25,000), and 50 percent of the country Y taxes (\$12,500). B is allocated 25 percent of the income from business M (\$25,000), 25 percent of the country X taxes (\$2,500), 50 percent of the income from business N (\$25,000), and 50 percent of the country Y taxes (\$12,500).

(ii) Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each of business M and business N is income in separate CFTE categories. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the \$100,000 of net income attributable to business M is in the business M CFTE category and the \$50,000 of net income attributable to business N is in the business N CFTE category. Under paragraph (b)(4)(viii)(d)(1) of this section, the \$10,000 of country X taxes is allocated to the business M CFTE category and \$10,000 of the country Y taxes is allocated to the business N CFTE category. Under paragraph (b)(4)(viii)(d)(3) of this section, the additional \$15,000 of country Y tax imposed with respect to the inter-branch payment is assigned to the business N CFTE category. Therefore, the \$10,000 of country X taxes is related to the \$100,000 of net income in the business M CFTE category and the \$25,000 of country Y taxes is related to the \$50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the \$10,000 of country X taxes in the same proportion as the distributive shares of income to which the taxes relate and the \$25,000 of country Y taxes in the same proportion as the distributive shares of income to which the taxes relate, AB satisfies the requirements of paragraph (b)(4)(viii) of this section and the allocations of the country X and country Y taxes are deemed to be in accordance with the partners' interests in the partnership. No inference is intended with respect to the application of other provisions to arrangements that involve disregarded payments. See paragraph (b)(1)(iii) of this section (relating to the ef-

fect of sections of the Internal Revenue Code other than section 704(b)).

(iii) Assume that the facts are the same as paragraph (i) of this *Example 24*, except that the partnership agreement provides that the \$15,000 of country Y tax imposed with respect to the inter-branch payment is allocated 75 percent to A (\$11,250) and 25 percent to B (\$3,750) and that the remaining \$10,000 of country Y tax is allocated 50 percent to A (\$5,000) and 50 percent to B (\$5,000). Thus, the country Y taxes are allocated 65 percent to A and 35 percent to B while the income in the business N CFTE category is allocated 50 percent to A and 50 percent to B. The allocations of the country Y tax are not deemed to be in accordance with the partners' interests because they are not in proportion to the allocations of the distributive shares of income from the business N CFTE category. However, upon sufficient substantiation that \$15,000 of country Y tax paid by DE2 with respect to the \$75,000 inter-branch payment relates to income that is recognized by DE1 for U.S. tax purposes, the allocations of the country Y taxes may be established to be actually in accordance with the partners' interests in the partnership. The allocations of the \$10,000 of country X taxes are deemed to be in accordance with the partners' interests in the partnership because the country X taxes are allocated in the same proportion as the distributive shares of income to which they relate.

(iv) Assume that the facts are the same as in paragraph (i) of this *Example 24*, except that in order to reflect the \$75,000 payment from DE1 to DE2, the partnership agreement allocates \$75,000 of the income attributable to business M equally between A and B (50 percent each). Therefore, the total income attributable to business M is allocated 56.25 percent to A (75 percent of \$25,000 plus 50 percent of \$75,000) and 43.75 percent to B (25 percent of \$25,000 and 50 percent of \$75,000). The allocation of the country X taxes (75 percent to A and 25 percent to B) is not deemed to be in accordance with the partners' interests because it is not in proportion to the allocations of the distributive shares of income from the business M CFTE category. However, upon sufficient substantiation that all \$10,000 of country X tax paid by DE1 relates to the \$25,000 of DE1's income that is shared in the same 75–25 ratio, the allocations of the country X taxes may be established to be actually in accordance with the partners' interests in the partnership. The allocations of the \$25,000 of country Y taxes are deemed to be in accordance with the partners' interests in the partnership because the country Y taxes are allocated in the same proportion as the distributive shares of income to which they relate.

Example 25. (i) A contributes \$750,000 and B contributes \$250,000 to form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X. Country X imposes a 20 percent tax on the net income from business M, which tax is a CFTE. In 2007, AB earns \$300,000 of gross income, has deductible expenses of \$100,000, and pays or accrues \$40,000 of country X tax. Pursuant to the partnership agreement, the first \$100,000 of gross income each year is allocated to A as a return on excess capital contributed by A. All remaining partnership items, including CFTEs, are split evenly between A and B (50 percent each). The gross income allocation is not deductible in determining AB's taxable income

under country X law. Assume that allocations of all items other than CFTEs are valid.

(ii) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. See paragraph (b)(4)(viii)(c)(2). Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the single CFTE category is \$200,000. The \$40,000 of taxes is allocated to the single CFTE category and, thus, related to the \$200,000 of net income in the single CFTE category. In 2007, AB's partnership agreement allocates \$150,000 or 75 percent of the net income to A (\$100,000 attributable to the gross income allocation plus \$50,000 of the remaining \$100,000 of net income) and \$50,000 or 25 percent of the net income to B. AB's partnership agreement allocates the country X taxes in accordance with the partners' shares of partnership items remaining after the \$100,000 gross income allocation. Therefore, AB allocates the country X taxes 50 percent to A (\$20,000) and 50 percent to B (\$20,000). AB's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section, because they are not in proportion to the allocations of the distributive shares of income to which the country X taxes relate. Accordingly, the country X taxes will be reallocated according to the partners' interest in the partnership. Assuming that the partners do not reasonably expect to claim a deduction for the CFTE in determining their U.S. tax liabilities, a reallocation of the CFTEs under paragraph (b)(3) of this section would be 75 percent to A (\$30,000) and 25 percent to B (\$10,000). If the reallocation of the CFTEs causes the partners' capital accounts not to reflect their contemplated economic arrangement, the partners may need to reallocate other partnership items to ensure that the tax consequences of the partnership's allocations are consistent with their contemplated economic arrangement over the term of the partnership. The Commissioner will not reallocate other partnership items after the reallocation of the CFTEs.

(iii) The facts are the same as in paragraph (i) of this Example 25, except that the \$100,000 allocation of gross income is deductible under country X law and that AB pays or accrues \$20,000 of foreign tax. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the single CFTE category is the \$100,000 of net income, determined by disregarding the \$100,000 of gross income that is allocated to A and deductible in determining AB's taxable income under the law of country X. See paragraph (b)(4)(viii)(c)(3)(ii) of this section. The \$20,000 of country X tax is allocated to the single CFTE category, and, thus, related to the \$100,000 of net income in the single CFTE category. See paragraphs (b)(4)(viii)(c)(1) and (d) of this section. No portion of the tax is related to the \$100,000 of gross income allocated to A. Pursuant to the partnership agreement, AB allocates the country X taxes 50 percent to A (\$10,000) and 50 percent to B (\$10,000). AB's allocations of country X taxes are deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section.

(iv) The results in (ii) and (iii) of this Example 25 would be the same assuming all of the facts except that, rather than being a preferential gross income allocation, the \$100,000 was a guaranteed payment to

A within the meaning of section 707(c). See paragraph (b)(4)(viii)(c)(3) of this section.

Example 26. (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and business N in country Y. A, a U.S. corporation, contributes a building with a fair market value of \$200,000 and an adjusted basis of \$50,000 for both U.S. and country X purposes. The building contributed by A is used in business M. B, a country X corporation, contributes \$800,000 cash. The AB partnership agreement provides that AB will make allocations under section 704(c) using the traditional method under §1.704-3(b) and that all other items, excluding creditable foreign taxes, will be allocated 20 percent to A and 80 percent to B. The partnership agreement provides that creditable foreign taxes will be allocated in proportion to the partners' distributive shares of net income in each CFTE category, which shall be determined by taking into account items allocated pursuant to section 704(c). Country X and Country Y impose tax at a rate of 20 percent and 40 percent, respectively, and such taxes are CFTEs. In 2007, AB sells the building contributed by A for \$200,000, thereby recognizing taxable income of \$150,000 for U.S. and country X purposes, and recognizes \$250,000 of other income from the operation of business M. AB pays or accrues \$80,000 of country X tax on such income. Also in 2007, business N recognizes \$100,000 of taxable income for U.S. and country Y purposes and pays or accrues \$40,000 of country Y tax. Pursuant to the partnership agreement, A is allocated \$200,000 of business M income (\$150,000 of taxable income in accordance with section 704(c) and \$50,000 of other business M income) and \$40,000 of country X tax, and 20 percent of both business N income (\$20,000) and country Y tax (\$8,000). B is allocated \$200,000 of business M income and \$40,000 of country X tax and 80 percent of both the business N income (\$80,000) and country Y tax (\$32,000). Assume that allocations of all items other than CFTEs are valid.

(ii) The net income attributable to business M (\$400,000) is allocated 50 percent to A and 50 percent to B while the net income attributable to business N (\$100,000) is allocated 20 percent to A and 80 percent to B. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each activity is income in a separate CFTE category. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the business M CFTE category is the \$400,000 of net income attributable to business M and the net income in the business N CFTE category is the \$100,000 of net income attributable to business N. Under paragraph (b)(4)(viii)(d)(1) of this section, the \$80,000 of country X tax is allocated to the business M CFTE category and the \$40,000 of country Y tax is allocated to the business N CFTE category. Therefore, the \$80,000 of country X tax relates to the \$400,000 of net income in the business M CFTE category and the \$40,000 of country Y tax relates to the \$100,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the \$80,000 of country X taxes and \$40,000 of country Y taxes in proportion to the distributive

shares of income to which such taxes relate, the allocations are deemed to be in accordance with the partners' interest in the partnership under paragraph (b)(4)(viii) of this section.

Example 27. (i) A, a U.S. citizen, and B, a country X citizen, form AB, a country X eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB's only activity is business M, which it operates in country X. Country X imposes a 40 percent tax on the portion of AB's business M income that is the allocable share of AB's owners that are not citizens of country X, which tax is a CFTE. The partnership agreement provides that all partnership items, excluding CFTEs, from business M are allocated 40 percent to A and 60 percent to B. CFTEs are allocated 100 percent to A. In 2007, AB earns \$100,000 of net income from business M and pays or accrues \$16,000 of country X taxes on A's allocable share of AB's income (\$40,000). Pursuant to the partnership agreement, A is allocated 40 percent of the business M income (\$40,000) and 100 percent of the country X taxes (\$16,000), and B is allocated 60 percent of the business M income (\$60,000) and no country X taxes. Assume that allocations of all items other than CFTEs are valid.

(ii) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. See paragraph (b)(4)(viii)(c)(2). Under paragraph (b)(4)(viii)(c)(3) of this section, the \$40,000 of business M income that is allocated to A is included in the single CFTE category. Under paragraph (b)(4)(viii)(c)(3)(ii) of this section, no portion of the \$60,000 allocated to B is included in the single CFTE category. Under paragraph (b)(4)(viii)(d) of this section, the \$16,000 of taxes is allocated to the single CFTE category.

Therefore, the \$16,000 of country X taxes is related to the \$40,000 of net income in the single CFTE category that is allocated to A. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the country X taxes in proportion to the distributive share of income to which the taxes relate, AB satisfies the requirement of paragraph (b)(4)(viii) of this section, and the allocation of the country X taxes is deemed to be in accordance with the partners' interests in the partnership.

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§1.704-1T [Removed]

Par. 3. Section 1.704-1T is removed.

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

Approved September 12, 2006.

Eric Solomon,
*Acting Deputy Assistant
Secretary of the Treasury.*

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Section 1016.—Adjustments to Basis

26 CFR 1.1016-3: Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

Rules are provided for reduction of basis for business use of an automobile under either the optional standard mileage rate method or a mileage allowance under a reimbursement or other expense allowance arrangement. See Rev. Proc. 2006-49, page 936.

Section 6662.—Imposition of Accuracy-Related Penalty on Underpayments

Guidance is provided concerning when information shown on a return in accordance with the applicable forms and instructions will be adequate disclosure under section 6662(d) for purposes of reducing an understatement of income tax. See Rev. Proc. 2006-48, page 934.

Section 6694.—Understatement of Taxpayer's Liability by Income Tax Return Preparer

Guidance is provided concerning when information shown on a return in accordance with the applicable forms and instructions will be adequate disclosure under section 6694(a) for purposes of reducing an understatement of income tax due to a return preparer's unrealistic position. See Rev. Proc. 2006-48, page 934.

Part III. Administrative, Procedural, and Miscellaneous

United States Income Tax Treaties That Meet the Requirements of Section 1(h)(11)(C)(i)(II)

Notice 2006-101

1. SUMMARY

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27, 117 Stat. 752) (the “2003 Act”) was enacted on May 28, 2003. Subject to certain limitations, the 2003 Act generally provides that a dividend paid to an individual shareholder from either a domestic corporation or a “qualified foreign corporation” is subject to tax at the reduced rates applicable to certain capital gains. A qualified foreign corporation includes certain foreign corporations that are eligible for benefits of a comprehensive income tax treaty with the United States that the Secretary determines is satisfactory for purposes of this provision and that includes an exchange of information provision. On October 20, 2003, the Service published Notice 2003-69, 2003-2 C.B. 851, which contains a list of the U.S. tax treaties that met these requirements at that time. This notice updates the list of U.S. tax treaties that meet these requirements to reflect new U.S. income tax treaties and protocols that have entered into force since the publication of Notice 2003-69.

2. ANALYSIS

Section 1(h)(1) of the Internal Revenue Code (the “Code”) generally provides that a taxpayer’s “net capital gain” for any taxable year will be subject to a maximum tax rate of 15 percent (or 5 percent in the case of certain taxpayers). The 2003 Act added section 1(h)(11), which provides that net capital gain for purposes of section 1(h) means net capital gain (determined without regard to section 1(h)(11)) increased by “qualified dividend income.” Qualified dividend income means dividends received during the taxable year from domestic corporations and “qualified foreign corporations.” Section 1(h)(11)(B)(i). Subject to certain exceptions, a qualified foreign corporation is any foreign corporation that is either (i) incorporated in a possession of the United States, or (ii) eligible for benefits of a comprehensive

income tax treaty with the United States that the Secretary determines is satisfactory for purposes of this provision and that includes an exchange of information program (the “treaty test”). Section 1(h)(11)(C)(i).

A foreign corporation that does not satisfy either of these two tests is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States. Section 1(h)(11)(C)(ii). See Notice 2003-71, 2003-2 C.B. 922, for the definition, for taxable years beginning on or after January 1, 2003, of “readily tradable on an established securities market in the United States.”

A qualified foreign corporation does not include any foreign corporation that for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company (as defined in section 1297). Section 1(h)(11)(C)(iii). A dividend from a qualified foreign corporation is also subject to the other limitations in section 1(h)(11). For example, a shareholder receiving a dividend from a qualified foreign corporation must satisfy the holding period requirements of section 1(h)(11)(B)(iii).

The appendix to this notice sets forth the current list of U.S. income tax treaties that meet the requirements of section 1(h)(11)(C)(i)(II). Three U.S. income tax treaties do not meet the requirements of section 1(h)(11)(C)(i)(II). The tax treaties with Bermuda and the Netherlands Antilles are not comprehensive income tax treaties within the meaning of section 1(h)(11). The U.S.-U.S.S.R. income tax treaty, which was signed on June 20, 1973, and currently applies to certain former Soviet Republics, does not include an information exchange program.

At the time Notice 2003-69 was published, the income tax treaty with Barbados was determined not to be satisfactory for purposes of section 1(h)(11) because of concern that the treaty may have operated to provide benefits that were intended to mitigate or eliminate double taxation in cases where there was no risk of double

taxation. *See, e.g.*, H.R. Rep. 108-126, 108th Cong., 1st Sess., at 42 (2003) (conference report on the 2003 Act). On July 14, 2004, the United States and Barbados signed a Second Protocol to the U.S.-Barbados income tax treaty (the “Second Protocol”), which entered into force on December 20, 2004. The Second Protocol amended the U.S.-Barbados income tax treaty by substituting a new limitation on benefits article that reflected developments in U.S. treaty policy and was designed to eliminate in particular the availability of certain inappropriate benefits under the existing treaty. Following the changes made by the Second Protocol, the income tax treaty with Barbados has been determined to be satisfactory for purposes of section 1(h)(11).

The updated list in the appendix to this notice also contains two U.S. income tax treaties that entered into force after the publication of Notice 2003-69: the U.S. income tax treaties with Sri Lanka (which entered into force on July 12, 2004) and Bangladesh (which entered into force on August 7, 2006).

Treasury and the IRS intend to update this list, as appropriate. Situations that may result in changes to the list include the entry into force of new income tax treaties and the amendment or renegotiation of existing tax treaties. Further, Treasury and the IRS continue to study the operation of each of our income tax treaties, including the implications of any change in the domestic laws of the treaty partner, to ensure that the treaty accomplishes its intended objectives and continues to be satisfactory for purposes of this provision. It is anticipated that any changes to the list of income tax treaties that meet the requirements of section 1(h)(11)(C)(i)(II) will apply only to dividends paid after the date of publication of the revised list.

Finally, in order to be treated as a qualified foreign corporation under the treaty test, a foreign corporation must be eligible for benefits of one of the U.S. income tax treaties listed in the Appendix. Accordingly, the foreign corporation must be a resident within the meaning of such term under the relevant treaty and must satisfy any other requirements of that treaty, in-

cluding the requirements under any applicable limitation on benefits provision.

3. EFFECTIVE DATE

This notice is effective with respect to Bangladesh for dividends paid on or after August 7, 2006. This notice is effective with respect to Barbados for dividends paid on or after December 20, 2004. This notice is effective with respect to Sri Lanka

for dividends paid on or after July 12, 2004. This notice is effective with respect to all other U.S. income tax treaties listed in the Appendix for taxable years beginning after December 31, 2002.

4. EFFECT ON OTHER DOCUMENTS

Notice 2003-69 is amplified and superseded.

5. CONTACT INFORMATION

The principal author of this notice is Ana C. Guzman of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Guzman at (202) 622-3880 (not a toll-free call).

APPENDIX U. S. INCOME TAX TREATIES SATISFYING THE REQUIREMENTS OF SECTION 1(h)(11)(C)(i)(II)

Australia	Germany	Lithuania	Slovenia
Austria	Greece	Luxembourg	South Africa
Bangladesh	Hungary	Mexico	Spain
Barbados	Iceland	Morocco	Sri Lanka
Belgium	India	Netherlands	Sweden
Canada	Indonesia	New Zealand	Switzerland
China	Ireland	Norway	Thailand
Cyprus	Israel	Pakistan	Trinidad and Tobago
Czech Republic	Italy	Philippines	Tunisia
Denmark	Jamaica	Poland	Turkey
Egypt	Japan	Portugal	Ukraine
Estonia	Kazakhstan	Romania	United Kingdom
Finland	Korea	Russian Federation	Venezuela
France	Latvia	Slovak Republic	

Patriots' Day Filings and Payments

Notice 2006-103

This notice provides guidance regarding the impact of Patriots' Day on the April 16, 2007 due date for filing Federal tax documents and making Federal tax payments. Individual income taxpayers residing in Maine, Massachusetts, New Hampshire, New York, Vermont, Maryland, and the District of Columbia have until Tuesday, April 17, 2007, to file documents in paper or electronic form that are otherwise due on April 16, 2007. These documents include U.S. individual income tax returns in the Form 1040 series and Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*. Individual income taxpayers in these states and the District of Columbia also have until April 17, 2007, to make Federal tax payments otherwise due on April 16, 2007, including the first installment of estimated tax for tax year 2007.

The additional time provided in this notice for filing returns and paying tax is not

available to individuals residing in other states, regardless of whether they file returns in paper or electronic form. Also, the additional time provided by this notice is not available for filing, or paying tax reported on, returns of taxpayers who are not individuals, such as Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and Form 1065, *U.S. Return of Partnership Income*, even though the taxpayer may be located in Massachusetts or Maine.

The principal author of this notice is John M. Moran of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice, contact John M. Moran at (202) 622-4940 (not a toll-free call).

26 CFR 1.861-8: Computation of taxable income from sources within the United States and from other sources and activities.

Rev. Proc. 2006-42

SECTION 1. PURPOSE

This revenue procedure sets forth the administrative procedures for taxpayers described in § 4 of this revenue pro-

cedure to obtain automatic approval to change certain elections relating to the apportionment of interest expense under §§ 1.861-8T(c)(2) and 1.861-9(i)(2) and research and experimental expenditures (R&E) under § 1.861-17(e). A taxpayer complying with this revenue procedure will be deemed to have obtained the approval of the Commissioner of the Internal Revenue Service (Commissioner) to change those elections.

SECTION 2. BACKGROUND

.01 DEDUCTION ATTRIBUTABLE TO DOMESTIC PRODUCTION ACTIVITIES.

(1) IN GENERAL. Section 199 of the Internal Revenue Code (Code), enacted as part of the American Jobs Creation Act of 2004, provides for a deduction attributable to domestic production activities. The deduction is equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to

section 199) for the taxable year (or, in the case of an individual, adjusted gross income (AGI)).

(2) DETERMINATION OF QPAI. To determine QPAI for a taxable year, a taxpayer must subtract from its domestic production gross receipts (DPGR) the cost of goods sold allocable to DPGR and other expenses, losses, or deductions (deductions) that are properly allocable to DPGR. Section 1.199-4(d) provides that a taxpayer generally must determine deductions allocable to DPGR, or to gross income attributable to DPGR, under the section 861 regulations.

.02 RULES FOR ALLOCATION AND APPORTIONMENT OF DEDUCTIONS.

(1) IN GENERAL. The section 861 regulations provide guidance for the allocation and apportionment of deductions in determining the taxable income of a taxpayer from specific sources and activities under sections of the Code, referred to as operative sections. Section 199 is treated as an operative section for purposes of the section 861 regulations. See § 1.199-4(d)(1).

(2) CONFORMITY OF APPLICATION. Where more than one operative section applies, the taxpayer may be required to apply the section 861 regulations separately for each applicable operative section. In that case, § 1.861-8(f)(2)(i) provides that the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections. See also § 1.199-4(d)(1).

.03 ALLOCATION AND APPORTIONMENT OF INTEREST EXPENSE.

(1) IN GENERAL. Taxpayers generally are required under §§ 1.861-8T(c)(2) and 1.861-9 to apportion interest expense on the basis of assets. Section 1.861-8T(c)(2) provides that the apportionment must be made either on the basis of the tax book value of the assets or on the fair market value of the assets. Section 1.861-9(i)(1) permits a taxpayer to elect to determine tax book value using the alternative tax book value method.

(2) BINDING ELECTION. Under § 1.861-8T(c)(2), once the taxpayer uses the fair market value method, the taxpayer and all related persons must continue to use that method unless expressly authorized by the Commissioner to change methods. Similarly, under

§ 1.861-9(i)(2)(i), if a taxpayer elects to use the alternative tax book value method, the taxpayer and all related persons may not, during the year of election and the four taxable years thereafter, determine tax book value under another method without the consent of the Commissioner. In Rev. Proc. 2005-28, 2005-1 C.B. 1093, the Commissioner provided automatic consent for taxpayers to change from the fair market value method to the alternative tax book value method, provided that certain requirements were met.

.04 ALLOCATION AND APPORTIONMENT OF RESEARCH AND EXPERIMENTAL EXPENDITURES.

(1) IN GENERAL. Pursuant to § 1.861-17, after allocating legally mandated R&E, if any, under § 1.861-17(a)(4) and exclusively apportioning applicable R&E, if any, under § 1.861-17(b)(1)(i), the remaining R&E of the taxpayer is apportioned under either the sales method of § 1.861-17(c) or one of the two gross income methods of § 1.861-17(d).

(2) BINDING ELECTION. Under § 1.861-17(e), a taxpayer may choose either the sales method or the optional gross income methods for the original return for its first taxable year to which § 1.861-17 applies. Once the method is elected, the taxpayer is required to use the method for that year and for the four taxable years thereafter. A taxpayer may not revoke its election of either method during the five-year period without the consent of the Commissioner.

.05 PREAMBLE OF FINAL REGULATIONS UNDER SECTION 199. The preamble to the final regulations under section 199 states that the Treasury Department and the IRS intend to issue a revenue procedure granting automatic consent to change elections under §§ 1.861-8T(c)(2) and 1.861-9(i)(1), respectively, to apportion interest expense and under § 1.861-17(e) to apportion R&E expense. Accordingly, this revenue procedure provides rules for obtaining that automatic consent.

SECTION 3. SCOPE

This revenue procedure applies to any taxpayer requesting to change (1) from the fair market value method under § 1.861-8T(c)(2) or from the alternative tax book value method under

§ 1.861-9(i)(1) to apportion interest expense or (2) from the sales method or the optional gross income methods under § 1.861-17(c) and (d) to apportion R&E expense. Notwithstanding these rules for obtaining automatic consent, a taxpayer may request under the regular ruling process the consent of the Commissioner to change one or more elections and, in the case of a taxpayer within the scope of Rev. Proc. 2005-28, obtain the consent of the Commissioner to change from the fair market value method by meeting the requirements of that revenue procedure.

SECTION 4. GENERAL APPLICATION PROCEDURES

.01 APPROVAL. The consent of the Commissioner is hereby granted, provided the taxpayer complies with all the applicable provisions of this revenue procedure, to any taxpayer within the scope of this revenue procedure to change its election:

(1) INTEREST EXPENSE. From the fair market value method under § 1.861-8T(c)(2) or the alternative tax book value method under § 1.861-9(i) of apportioning interest expense to another method; or

(2) R&E EXPENSE. From the sales method or the optional gross income methods under § 1.861-17(c) and (d) of apportioning R&E expense to another method.

.02 STATEMENT REQUIREMENT.

(1) A corporation shall request to change an election within the scope of this revenue procedure on a Form 1118 by attaching to Form 1118 the applicable statement set forth in § 4.02(2) of this revenue procedure. In the case of such taxpayers electronically filing Form 1118, the statement must be included in the electronic version of Form 1118. A taxpayer, other than a corporation, shall request to change an election within the scope of this revenue procedure on Form 1116 by attaching to Form 1116 one of the three statements, whichever is applicable, set forth in § 4.02(2) of this revenue procedure. In the case of such taxpayers electronically filing Form 1116, the statement must be entered into the Election Explanation Record of the electronic version of Form 1040, Form 1041, or other relevant form.

(2) The statement referred to in § 4.02(1) of this revenue procedure shall provide as follows:

(i) **INTEREST EXPENSE FROM FAIR MARKET VALUE METHOD.** “For the immediately preceding taxable year, [name of taxpayer] valued assets for purposes of interest expense apportionment using the fair market value method. Pursuant to Rev. Proc. 2006–42, [name of taxpayer] is changing from the fair market value method to the tax book value [alternative tax book value] method of asset valuation. This change to the tax book value [alternative tax book value] method applies beginning with [name of taxpayer]’s [XXXX] taxable year,”

(ii) **INTEREST EXPENSE FROM ALTERNATIVE TAX BOOK VALUE METHOD.** “For the immediately preceding taxable year, [name of taxpayer] valued assets for purposes of interest expense apportionment using the alternative tax book value method. Pursuant to Rev. Proc. 2006–42, [name of taxpayer] is revoking its election to determine tax book value using the alternative tax book value method. This change to the tax book value method applies beginning with [name of taxpayer]’s [XXXX] taxable year,” and/or

(iii) **R&E EXPENSE.** “For the immediately preceding taxable year, [name of taxpayer] apportioned R&E expense using the sales method as described in § 1.861–17(c) [one of the optional gross income methods as described in § 1.861–17(d)]. Pursuant to Rev. Proc. 2006–42, [name of taxpayer] is changing from the sales method [one of the optional gross income methods] to one of the optional gross income methods [sales method]. This change applies beginning with [name of taxpayer]’s [XXXX] taxable year.

.03 **DOCUMENTATION.** Any taxpayer that changes methods under this revenue procedure must maintain all documentation necessary to establish its change in method or methods and its eligibility for the benefits of this revenue procedure.

SECTION 5. REVIEW OF STATEMENT

The appropriate director of the Internal Revenue Service (within the meaning of § 1.01(3) of Rev. Proc. 2006–1, 2006–1 I.R.B. 1) may ascertain if the tax-

payer changed its election(s) in compliance with all the applicable provisions of this revenue procedure. A taxpayer changing its election(s) pursuant to this revenue procedure without complying with all the provisions (including the terms and conditions) of this revenue procedure ordinarily will be deemed to have initiated the change in election(s) without the approval of the Commissioner. Upon examination, a taxpayer that has initiated an unauthorized change of election(s) may be denied the change. For example, the taxpayer may be required to redetermine its apportioned interest and/or R&E expense in accordance with its former election(s).

SECTION 6. EFFECTIVE DATE, DEADLINE, AND TRANSITION RULE

.01 **EFFECTIVE DATE.** This revenue procedure is effective for either:

(1) a taxpayer’s first taxable year beginning after December 31, 2004 (the taxpayer’s 2005 taxable year); or

(2) a taxpayer’s first taxable year immediately following the taxpayer’s 2005 taxable year, but only with respect to elections that first took effect in a taxable year preceding the taxpayer’s 2005 taxable year.

.02 **DEADLINE.** This revenue procedure is effective only if the taxpayer submits the statement(s) required by § 4.02 of this revenue procedure by the later of (i) one year after October 30, 2006, or (ii) the due date (including extensions) of the taxpayer’s income tax return to which the statement(s) relates.

.03 **TRANSITION RULE.** If a taxpayer within the scope of this revenue procedure filed an application to change an election(s) to which the revenue procedure applies with the national office and the application is pending with the national office on October 30, 2006, the taxpayer may obtain approval under this revenue procedure. However, the national office will process the application in accordance with the authority under which it was filed, unless the taxpayer notifies the national office that the taxpayer wants to use this revenue procedure before the national office issues the letter ruling granting or denying approval for the change. If the taxpayer timely notifies the national office that it wants to use this revenue procedure,

the national office will close out the previously filed application. In addition, any user fee that was submitted with the previously filed application will be refunded to the taxpayer.

SECTION 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–2040. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number. The collections of information in this revenue procedure are found in § 4.02 and .03 of this revenue procedure. The information is required in order to determine whether the taxpayer properly obtained automatic approval to change an election within the scope of this revenue procedure. The likely respondents are the following: corporations, partnerships, S corporations, and individuals. The estimated total annual reporting burden for the requirements contained in § 4.02 and .03 of this revenue procedure is 100 hours: the estimated annual burden per respondent is 30 minutes; the estimated number of respondents is 200; and the estimated frequency of response is occasional. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. § 6103.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Richard L. Chewning of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Richard L. Chewning at (202) 622–3850 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

(Also: Part 1, §§ 6662, 6694; 1.6662-4, 1.6694-2.)

Rev. Proc. 2006-48

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2005-75, 2005-50 I.R.B. 1137, and identifies circumstances under which the disclosure on a taxpayer's return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under section 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under section 6694(a) (relating to understatements due to unrealistic positions). This revenue procedure does not apply with respect to any other penalty provisions (including the disregard provisions of the section 6662 accuracy-related penalty, which are subject to an exception for adequate disclosure).

This revenue procedure applies to any return filed on 2006 tax forms for a taxable year beginning in 2006, and to any return filed on 2006 tax forms in 2007 for short taxable years beginning in 2007.

SECTION 2. CHANGES FROM REV. PROC. 2005-75

.01. Editorial changes have been made in updating Rev. Proc. 2005-75.

.02. Section 4.02(3) concerning difference in book and income tax reporting is expanded by adding new Schedules M-3 for Forms 1065, *U.S. Return of Partnership Income*, 1120-L, *U.S. Life Insurance Company Income Tax Return*, 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*, 1120S, *U.S. Income Tax Return for an S Corporation*, which reconcile net income (loss) in the financial statements to that shown on an entity's return.

SECTION 3. BACKGROUND

.01 If section 6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20 percent of the portion of the under-

payment to which the section applies is added to the tax. (The penalty rate is 40 percent in the case of gross valuation misstatements under section 6662(h).) Section 6662(b)(2) applies to the portion of an underpayment of tax that is attributable to a substantial understatement of income tax.

.02 Section 6662(d)(1) provides that there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to be shown on the return for the taxable year or \$5,000. Section 6662(d)(1)(B) provides special rules for corporations. A corporation (other than an S corporation or personal holding company) has a substantial understatement of income tax if the amount of the understatement exceeds the lesser of 10 percent of the tax required to be shown on the return for a taxable year (or, if greater, \$10,000) or \$10,000,000. Section 6662(d)(2) defines an understatement as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate (within the meaning of section 6211(b)(2)).

.03 In the case of an item not attributable to a tax shelter, section 6662(d)(2)(B)(ii) provides that the amount of the understatement is reduced by the portion of the understatement attributable to any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the tax treatment of the item by the taxpayer.

.04 Section 6694 imposes a penalty of \$250 on an income tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a position for which the preparer knew or should have known that there was not a realistic possibility of being sustained on the merits and the position was not disclosed in accordance with section 6662(d)(2)(B)(ii).

.05 In general, this revenue procedure provides guidance for determining when disclosure is adequate for purposes of section 6662(d)(2)(B)(ii) and section 6694(a)(3). For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms and instructions, and

the money amounts entered on these forms must be verifiable. Annual guidance under Treas. Reg. § 1.6662-4(f)(2) and Treas. Reg. § 1.6694-3(e)(1) and (2) for returns filed on 2005, 2004, and 2003 tax forms is provided in Rev. Proc. 2005-75, Rev. Proc. 2004-73, 2004-2 C.B. 999, and Rev. Proc. 2003-77, 2003-2 C.B. 964, respectively.

.06 Fiscal and short tax year returns. (a) In general. This revenue procedure may apply to a return for a fiscal tax year that begins in 2006 and ends in 2007. This revenue procedure may also apply to a short year return for a period beginning in 2007 where the return is to be filed before the 2007 forms are available. (Note that individuals are generally not put in this position as a decedent's final return for a fractional part of a year is due the fifteenth day of the fourth month following the close of the 12-month period which began with the first day of such fractional part of the year. See Treas. Reg. section 1.6072-1(b).) In the case of fiscal year and short year returns, the taxpayer must take into account any tax law changes that are effective for tax years beginning after December 31, 2006, even though these changes are not reflected on the form.

(b) Tax law changes effective after December 31, 2006. This document does not take into account the effect of tax law changes effective for tax years beginning after December 31, 2006. If a line referenced in this revenue procedure is affected by such a change and requires additional reporting, a taxpayer may have to file Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*, until the Service prescribes criteria for complying with the requirement.

SECTION 4. PROCEDURE

.01 General.

(1) Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under section 6662(d) (except as otherwise provided in section 4.02(3) concerning Schedules M-1 and M-3), provided that the forms and attachments are completed in a clear manner and in accordance with their instructions.

(2) The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the Internal Revenue Service) and the taxpayer can show good faith in entering that number on the applicable form.

(3) The disclosure of an amount as provided in section 4.02 below is not adequate when the understatement arises from a transaction between related parties. If an entry may present a legal issue or controversy because of a related party transaction, then that transaction and the relationship must be disclosed on a Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*.

(4) Where the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an "Other Expense" category) the taxpayer must clearly identify the item by including the description on that line. For example, to disclose a bad debt for a sole proprietorship, the words "bad debt" must be written or typed on the line of Schedule C that shows the amount of the bad debt. Also, for Schedule M-3 (Form 1120), Part II, line 25, Other income (loss) items with differences, or Part III, line 35, Other expense/deduction items with differences, the entry must provide descriptive language; for example, "Cost of non-compete agreement deductible not capitalizable." If space limitations on a form do not allow for an adequate description, the description must be continued on an attachment.

(5) Although a taxpayer may literally meet the disclosure requirements of this revenue procedure, the disclosure will have no effect for purposes of the section 6662 accuracy-related penalty if the item or position on the return: (1) Does not have a reasonable basis as defined in Treas. Reg. § 1.6662-3(b)(3); (2) Is attributable to a tax shelter item as defined in section 6662(d)(2) and Treas. Reg. § 1.6662-4(g); or (3) Is not properly substantiated or the taxpayer failed to keep adequate books and records with respect to the item or position. See Treas. Reg. § 1.6694-2(c) regarding limitations on the

effectiveness of a disclosure regarding the section 6694 return preparer penalty.

.02 Items.

(1) Form 1040, Schedule A, *Itemized Deductions*:

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

(c) Interest Expenses: Complete lines 10 through 14, supplying all required information. This section 4.02(1)(c) does not apply to (i) amounts disallowed under section 163(d) unless Form 4952, *Investment Interest Expense Deduction*, is completed, or (ii) amounts disallowed under section 265.

(d) Contributions: Complete lines 15 through 18, supplying all required information. Enter the amount of the contribution reduced by the value of any substantial benefit (goods or services) provided by the donee organization in consideration, in whole or in part. Entering the value of the contribution unreduced by the value of the benefit received will not constitute adequate disclosure. If a contribution of \$250 or more is made, this section will not apply unless a contemporaneous written acknowledgment, as required by section 170(f)(8), is obtained from the donee organization. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds \$500, attach a properly completed Form 8283, *Noncash Charitable Contributions*, to the return. In addition to the Form 8283, if a contribution of a qualified motor vehicle, boat, or airplane has a value of more than \$500, this section will not apply unless a contemporaneous written acknowledgment, as required by section 170(f)(12), is obtained from the donee organization and attached to the return. An acknowledgment under section 170(f)(8) is not required if an acknowledgment under section 170(f)(12) is required.

(e) Casualty and Theft Losses: Complete Form 4684, *Casualties and Thefts*, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) Certain Trade or Business Expenses (including, for purposes of this section, the

following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in section 4.02(1)(e) must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or non-deductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

(c) Specific Bad Debt Charge-off: The amount written off must be stated.

(d) Reasonableness of Officers' Compensation: Form 1120, Schedule E, *Compensation of Officers*, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This section does not apply to "golden parachute" payments, as defined under section 280G. This section will not apply to the extent that remuneration paid or incurred exceeds the \$1 million-employee-remuneration limitation, if applicable.

(e) Repair Expenses: The amount claimed must be stated. This section does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated.

(3) Differences in book and income tax reporting.

(a) Form 1065. Schedule M-3 (Form 1065), *Net Income (Loss) Reconciliation for Certain Partnerships*: Column (b), *Temporary Difference*, and Column (c), *Permanent Difference*, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

(b) Form 1120. (i) Schedule M-1, *Reconciliation of Income (Loss) per Books With Income per Return*.

(ii) Schedule M-3 (Form 1120), *Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More*: Column (b), *Temporary Difference*, and Column (c), *Permanent Difference*, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

(c) Form 1120-L. Schedule M-3 (Form 1120-L), *Net Income (Loss) Reconcilia-*

tion for U.S. Life Insurance Companies With Total Assets of \$10 Million or More: Column (b), *Temporary Difference*, and Column (c), *Permanent Difference*, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

(d) Form 1120-PC. Schedule M-3 (Form 1120-PC), *Net Income (Loss) Reconciliation for U.S. Property and Casualty Insurance Companies With Total Assets of \$10 Million or More*: Column (b), *Temporary Difference*, and Column (c), *Permanent Difference*, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

(e) Form 1120-S. Schedule M-3 (Form 1120S), *Net Income (Loss) Reconciliation for S Corporations With Total Assets of \$10 Million or More*: Column (b), *Temporary Difference*, and Column (c), *Permanent Difference*, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

For Schedule M-1 and all Schedules M-3, the information provided reasonably must be expected to apprise the Service of the nature of the potential controversy concerning the tax treatment of the item. If the information provided does not so apprise the Service, a Form 8275 or Form 8275-R, must be used to adequately disclose the item (see Part II of the instructions for those forms).

Note: An item reported on a line with a pre-printed description, shown on an attached schedule, or "itemized" on Schedule M-1 may represent the aggregate amount of several transactions producing that item (*i.e.*, a group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business). In some instances, the potentially controversial item may involve a portion of the amount disclosed on the schedule. The Service will not be reasonably apprised of the potential controversy by the amount disclosed. In these instances, the taxpayer must use Form 8275 or Form 8275-R regarding that portion of the item.

The combining of unlike items, whether on Schedule M-1 or Schedule M-3 (or on an

attachment when directed by the instructions), will not constitute an adequate disclosure.

(4) Foreign Tax Items:

(a) International Boycott Transactions: Transactions disclosed on Form 5713, *International Boycott Report*. Schedule A, *International Boycott Factor (Section 999(c)(1))*; Schedule B, *Specifically Attributable Taxes and Income (Section 999(c)(2))*; and Schedule C, *Tax Effect of the International Boycott Provisions*, must be completed when required by their instructions.

(b) Treaty-Based Return Position: Transactions and amounts under section 6114 or section 7701(b) as disclosed on Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*.

(5) Other:

(a) Moving Expenses: Complete Form 3903, *Moving Expenses*, and attach to the return.

(b) Employee Business Expenses: Complete Form 2106, *Employee Business Expenses*, or Form 2106-EZ, *Unreimbursed Employee Business Expenses*, and attach to the return. This section does not apply to club dues, or to travel expenses for any non-employee accompanying the taxpayer on the trip.

(c) Fuels Credit: Complete Form 4136, *Credit for Federal Tax Paid on Fuels*, and attach to the return.

(d) Investment Credit: Complete Form 3468, *Investment Credit*, and attach to the return.

SECTION 5. EFFECTIVE DATE

This revenue procedure applies to any return filed on a 2006 tax form for a taxable year beginning in 2006, and to any return filed on a 2006 tax form in 2007 for a short taxable year beginning in 2007.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is John M. Moran of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue procedure, contact

John M. Moran at (202) 622-4940 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 62, 162, 170, 213, 217, 274, 1016; 1.62-2, 1.162-17, 1.170A-1, 1.213-1, 1.217-2, 1.274-5, 1.1016-3.)

Rev. Proc. 2006-49

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2005-78, 2005-2 C.B. 1177, and provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee are deemed substantiated under § 1.274-5 of the Income Tax Regulations if a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for the expenses. Use of a method of substantiation described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. The Internal Revenue Service prospectively adjusts the business and medical and moving standard mileage rates annually (to the extent warranted).

SECTION 2. SUMMARY OF STANDARD MILEAGE RATES

.01 Standard mileage rates

(1) Business (section 5 below)	48.5 cents per mile
(2) Charitable contribution (section 7 below)	14 cents per mile
(3) Medical and moving (section 7 below)	20 cents per mile

.02 *Determination of standard mileage rates.* The business and medical and moving standard mileage rates reflected in this revenue procedure are based on an annual study of the fixed and variable costs of operating an automobile conducted on behalf of the Service by an independent contractor. The charitable contribution standard mileage rate is provided in § 170(i) of the Internal Revenue Code.

SECTION 3. BACKGROUND AND CHANGES

.01 Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct the cost of operating an automobile to the extent that it is used in a trade or business. However, under § 262, no portion of the cost of operating an automobile that is attributable to personal use is deductible.

.02 Section 274(d) provides, in part, that no deduction is allowed under § 162 with respect to any listed property (as defined in § 280F(d)(4) to include passenger automobiles and any other property used as a means of transportation) unless the taxpayer complies with certain substantiation requirements. Section 274(d) further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by the regulations.

.03 Section 1.274-5(j), in part, grants the Commissioner of Internal Revenue the authority to establish a method under which a taxpayer may use mileage rates to substantiate, for purposes of § 274(d), the amount of the ordinary and necessary expenses of using a vehicle for local transportation and transportation to, from, and at the destination while traveling away from home.

.04 Section 1.274-5(g), in part, grants the Commissioner the authority to prescribe rules relating to mileage allowances for ordinary and necessary expenses of

using a vehicle for local transportation and transportation to, from, and at the destination while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which the allowances, if in accordance with reasonable business practice, will be regarded as (1) equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of the travel and transportation expenses for purposes of § 1.274-5(c), and (2) satisfying the requirements of an adequate accounting to the employer of the amount of the expenses for purposes of § 1.274-5(f).

.05 Section 62(a)(2)(A) allows an employee, in determining adjusted gross income, a deduction for the expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein do not apply to any expense to the extent that, under the grant of regulatory authority in § 274(d), the Commissioner has provided that substantiation is not required for the expense.

.07 Under § 1.62-2(c)(1), a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62-2(e)(2) specifically provides

that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274-5(g) will be treated as substantiation of the amount of the expenses for purposes of § 1.62-2. Under § 1.62-2(f)(2), the Commissioner may prescribe rules under which an arrangement providing mileage allowances is treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of the allowance that relates to miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of the allowance that relates to miles of travel not substantiated.

.08 Section 1.62-2(h)(2)(i)(B) provides that if a payor pays a mileage allowance under an arrangement that meets the requirements of § 1.62-2(c)(1), the portion, if any, of the allowance that relates to miles of travel substantiated in accordance with § 1.62-2(e), that exceeds the amount of the employee's expenses deemed substantiated for the travel pursuant to rules prescribed under § 274(d) and § 1.274-5(g), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)-3, 31.3231(e)-1(a)(5), 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62-2(g) (relating to the return of excess amounts) do not apply to this excess portion.

.09 Under § 1.62-2(h)(2)(i)(B)(4), the Commissioner may provide special rules regarding the timing of withholding and payment of employment taxes on mileage allowances.

.10 Section 303 of the Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2016 (KETRA)

provides a special standard mileage rate for purposes of computing the amount allowable as a charitable contribution deduction for the cost of operating an automobile for the provision of relief related to Hurricane Katrina during the period beginning on August 25, 2005, and ending on December 31, 2006. Section 304 of KETRA provides that taxpayers may exclude from income amounts received from a charity as reimbursement for the cost of operating an automobile for the provision of relief related to Hurricane Katrina during the period beginning on August 25, 2005, and ending on December 31, 2006. Because these provisions expire after December 31, 2006, sections 2.01 and 7.01 of this revenue procedure are revised to remove these special charitable contribution standard mileage rates for 2007.

SECTION 4. DEFINITIONS

.01 *Standard mileage rate.* The term “standard mileage rate” means the applicable amount provided by the Service for optional use by employees or self-employed individuals in computing the deductible costs of operating automobiles (including vans, pickups, or panel trucks) they own or lease for business purposes, or by taxpayers in computing the deductible costs of operating automobiles for charitable, medical, or moving expense purposes.

.02 *Transportation expenses.* The term “transportation expenses” means the expenses of operating an automobile for local travel or transportation away from home.

.03 *Mileage allowance.* The term “mileage allowance” means a payment under a reimbursement or other expense allowance arrangement that is:

(1) paid with respect to the ordinary and necessary business expenses incurred, or that the payor reasonably anticipates will be incurred, by an employee for transportation expenses in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at the applicable standard mileage rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.04 *Flat rate or stated schedule.* A mileage allowance is paid at a flat rate or

stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 4.03 of this revenue procedure. The allowance may be paid periodically at a fixed rate, at a cents-per-mile rate, at a variable rate based on a stated schedule, at a rate that combines any of these rates, or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, a periodic payment at a fixed rate to cover the fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving an automobile in connection with the performance of services as an employee of the employer, coupled with a periodic payment at a cents-per-mile rate to cover the variable costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of using an automobile for those purposes, is an allowance paid at a flat rate or stated schedule. Likewise, a periodic payment at a variable rate based on a stated schedule for different locales to cover the costs of driving an automobile in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

SECTION 5. BUSINESS STANDARD MILEAGE RATE

.01 *In general.* The standard mileage rate for transportation expenses is 48.5 cents per mile for all miles of use for business purposes.

.02 *Use of the business standard mileage rate.* A taxpayer may use the business standard mileage rate with respect to an automobile that is either owned or leased by the taxpayer. A taxpayer generally may deduct an amount equal to either the business standard mileage rate times the number of business miles traveled or the actual costs (both fixed and variable) paid or incurred by the taxpayer that are allocable to traveling those business miles.

.03 *Business standard mileage rate in lieu of fixed and variable costs.* A deduction using the business standard mileage rate is computed on a yearly basis and is in lieu of all fixed and variable costs of the automobile allocable to business purposes (except as provided in section 9.06 of this revenue procedure). Items such as depre-

ciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees are included in fixed and variable costs for this purpose.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to use of the automobile for business purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local personal property taxes may be deducted as separate items, but only to the extent allowable under § 163 or § 164, respectively. Section 163(h)(2)(A) expressly provides that interest is nondeductible personal interest if it is paid or accrued on indebtedness properly allocable to the trade or business of performing services as an employee. Section 164 expressly provides that state and local taxes that are paid or accrued by a taxpayer in connection with an acquisition or disposition of property are treated as part of the cost of the acquired property or as a reduction in the amount realized on the disposition of the property. If the automobile is operated less than 100 percent for business purposes, an allocation is required to determine the business and nonbusiness portion of the taxes and interest deduction allowable.

.05 *Depreciation.* For owned automobiles placed in service for business purposes, and for which the business standard mileage rate has been used for any year, depreciation is considered to have been allowed at the rate of 16 cents per mile for 2003 and 2004, 17 cents per mile for 2005 and 2006, and 19 cents per mile for 2007, for those years in which the business standard mileage rate was used. If actual costs were used for one or more of those years, these rates do not apply to any year in which actual costs were used. The depreciation described above reduces the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016.

.06 *Limitations.*

(1) The business standard mileage rate may not be used to compute the deductible expenses of (a) automobiles used for hire, such as taxicabs, or (b) five or more automobiles owned or leased by a taxpayer and used simultaneously (such as in fleet operations).

(2) The business standard mileage rate may not be used to compute the deductible

business expenses of an automobile leased by a taxpayer unless the taxpayer uses either the business standard mileage rate or a fixed and variable rate allowance (FAVR allowance) (as provided in section 8 of this revenue procedure) to compute the deductible business expenses of the automobile for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(3) The business standard mileage rate may not be used to compute the deductible expenses of an automobile for which the taxpayer has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, (c) claimed the special depreciation allowance under § 168(k), or (d) used the Accelerated Cost Recovery System (ACRS) under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. By using the business standard mileage rate, the taxpayer has elected to exclude the automobile (if owned) from MACRS pursuant to § 168(f)(1). If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(4) The business standard mileage rate and this revenue procedure may not be used to compute the amount of the deductible automobile expenses of an employee of the United States Postal Service incurred in performing services involving the collection and delivery of mail on a rural route if the employee receives qualified reimbursements (as defined in § 162(o)) for the expenses. See § 162(o) for the rules that apply to these qualified reimbursements.

SECTION 6. RESERVED

SECTION 7. CHARITABLE AND MEDICAL AND MOVING STANDARD MILEAGE RATES

.01 *Charitable.* Section 170(i) provides a standard mileage rate of 14 cents per mile for purposes of computing the charitable contribution deduction for use of an auto-

mobile in connection with rendering gratuitous services to a charitable organization under § 170.

.02 *Medical and moving.* The standard mileage rate is 20 cents per mile for use of an automobile (1) to obtain medical care described in § 213, or (2) as part of a move for which the expenses are deductible under § 217.

.03 *Charitable or medical and moving standard mileage rates in lieu of variable expenses.* A deduction computed using the applicable standard mileage rate for charitable, medical, or moving expense miles is in lieu of all variable expenses (including gasoline and oil) of the automobile allocable to those purposes. Costs for items such as depreciation (or lease payments), insurance, and license and registration fees are not deductible, and are not included in the charitable or medical and moving standard mileage rates.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to the use of the automobile for charitable, medical, or moving expense purposes may be deducted as separate items. Interest relating to the purchase of the automobile and state and local personal property taxes are not deductible as charitable, medical, or moving expenses, but they may be deducted as separate items to the extent allowable under § 163 or § 164, respectively.

SECTION 8. FIXED AND VARIABLE RATE ALLOWANCE

.01 *In general.*

(1) The ordinary and necessary expenses paid or incurred by an employee in driving an automobile owned or leased by the employee in connection with the performance of services as an employee of the employer are deemed substantiated (in an amount determined under section 9 of this revenue procedure) when a payor reimburses those expenses with a mileage allowance using a flat rate or stated schedule that combines periodic fixed and variable rate payments that meet all the requirements of section 8 of this revenue procedure (a FAVR allowance).

(2) The amount of a FAVR allowance must be based on data that (a) is derived from the base locality, (b) reflects retail prices paid by consumers, and (c) is reasonable and statistically defensible in ap-

proximating the actual expenses employees receiving the allowance would incur as owners of the standard automobile.

.02 *Computation of FAVR allowance.*

(1) *FAVR allowance.* A FAVR allowance includes periodic fixed payments and periodic variable payments. A payor may maintain more than one FAVR allowance. A FAVR allowance that uses the same payor, standard automobile (or an automobile of the same make and model that is comparably equipped), retention period, and business use percentage is considered one FAVR allowance, even though other features of the allowance may vary. A FAVR allowance also includes any optional high mileage payments; however, optional high mileage payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes when paid. See section 9.05 of this revenue procedure. An optional high mileage payment covers the additional depreciation for a standard automobile attributable to business miles driven and substantiated by the employee for a calendar year in excess of the annual business mileage for that year. If an employee is covered by the FAVR allowance for less than the entire calendar year, the annual business mileage may be prorated on a monthly basis for purposes of the preceding sentence.

(2) *Periodic fixed payment.* A periodic fixed payment covers the projected fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving the standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. A periodic fixed payment may be computed by (a) dividing the total projected fixed costs of the standard automobile for all years of the retention period, determined at the beginning of the retention period, by the number of periodic fixed payments in the retention period, and (b) multiplying the resulting amount by the business use percentage.

(3) *Periodic variable payment.* A periodic variable payment covers the projected variable costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of driving a standard

automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. The rate of a periodic variable payment for a computation period may be computed by dividing the total projected variable costs for the standard automobile for the computation period, determined at the beginning of the computation period, by the computation period mileage. A computation period can be any period of a year or less. Computation period mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a computation period and equals the retention mileage divided by the number of computation periods in the retention period. For each business mile substantiated by the employee for the computation period, the periodic variable payment must be paid at a rate that does not exceed the rate for that computation period.

(4) *Base locality.* A base locality is the particular geographic locality or region of the United States in which the costs of driving an automobile in connection with the performance of services as

an employee of the employer are generally paid or incurred by the employee. Thus, for purposes of determining the amount of fixed costs, the base locality is generally the geographic locality or region in which the employee resides. For purposes of determining the amount of variable costs, the base locality is generally the geographic locality or region in which the employee drives the automobile in connection with the performance of services as an employee of the employer.

(5) *Standard automobile.* A standard automobile is the automobile selected by the payor on which a specific FAVR allowance is based.

(6) *Standard automobile cost.* The standard automobile cost for a calendar year may not exceed 95 percent of the sum of (a) the retail dealer invoice cost of the standard automobile in the base locality, and (b) state and local sales or use taxes applicable on the purchase of the automobile. Further, the standard automobile cost may not exceed \$27,600.

(7) *Annual mileage.* Annual mileage is the total mileage (business and personal) a payor reasonably projects a standard au-

tomobile will be driven during a calendar year. Annual mileage equals the annual business mileage divided by the business use percentage.

(8) *Annual business mileage.* Annual business mileage is the mileage a payor reasonably projects a standard automobile will be driven by an employee in connection with the performance of services as an employee of the employer during the calendar year, but may not be less than 6,250 miles for a calendar year. Annual business mileage equals the annual mileage multiplied by the business use percentage.

(9) *Business use percentage.* A business use percentage is determined by dividing the annual business mileage by the annual mileage. The business use percentage may not exceed 75 percent. In lieu of demonstrating the reasonableness of the business use percentage based on records of total mileage and business mileage driven by the employees annually, a payor may use a business use percentage that is less than or equal to the following percentages for a FAVR allowance that is paid for the following annual business mileage:

<i>Annual business mileage</i>	<i>Business use percentage</i>
6,250 or more but less than 10,000	45 percent
10,000 or more but less than 15,000	55 percent
15,000 or more but less than 20,000	65 percent
20,000 or more	75 percent

(10) *Retention period.* A retention period is the period in calendar years selected by the payor during which the payor expects an employee to drive a standard automobile in connection with the performance of services as an employee of the employer before the automobile is replaced. The

period may not be less than two calendar years.

(11) *Retention mileage.* Retention mileage is the annual mileage multiplied by the number of calendar years in the retention period.

(12) *Residual value.* The residual value of a standard automobile is the projected

amount for which it could be sold at the end of the retention period after being driven the retention mileage. The Service will accept the following safe harbor residual values for a standard automobile computed as a percentage of the standard automobile cost:

<i>Retention period</i>	<i>Residual value</i>
2-year	70 percent
3-year	60 percent
4-year	50 percent

.03 FAVR allowance in lieu of fixed and variable costs.

(1) A reimbursement computed using a FAVR allowance is in lieu of the em-

ployee's deduction of all the fixed and variable costs paid or incurred by an employee in driving the automobile in connection with the performance of services

as an employee of the employer, except as provided in section 9.06 of this revenue procedure. Items such as depreciation (or lease payments), maintenance and

repairs, tires, gasoline (including all taxes thereon), oil, insurance, license and registration fees, and personal property taxes are included in fixed and variable costs for this purpose.

(2) Parking fees and tolls attributable to an employee driving the standard automobile in connection with the performance of services as an employee of the employer are not included in fixed and variable costs and may be deducted as separate items. Similarly, interest relating to the purchase of the standard automobile may be deducted as a separate item, but only to the extent that the interest is an allowable deduction under § 163.

.04 Depreciation.

(1) A FAVR allowance may not be paid with respect to an automobile for which the employee has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, (c) claimed the special depreciation allowance under § 168(k), or (d) used ACRS under former § 168 or MACRS under current § 168. If an employee uses actual costs for an owned automobile that has been covered by a FAVR allowance, the employee must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(2) Except as provided in section 8.04(3) of this revenue procedure, the total amount of the depreciation component for the retention period taken into account in computing the periodic fixed payments for that retention period may not exceed the excess of the standard automobile cost over the residual value of the standard automobile. In addition, the total amount of the depreciation component may not exceed the sum of the annual § 280F limitations on depreciation (in effect at the beginning of the retention period) that apply to the standard automobile during the retention period.

(3) If the depreciation component of periodic fixed payments exceeds the limitations in section 8.04(2) of this revenue procedure, that section will be treated as satisfied in any year during which the total annual amount of the periodic fixed payments and the periodic variable payments made to an employee driving 80 percent of the annual business mileage of the standard automobile does not exceed the

amount obtained by multiplying 80 percent of the annual business mileage of the standard automobile by the business standard mileage rate for that year (under section 5.01 of the applicable revenue procedure).

(4) The depreciation included in each periodic fixed payment portion of a FAVR allowance paid with respect to an automobile reduces the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016. See section 8.07(2) of this revenue procedure for the requirement that the employer report the depreciation component of a periodic fixed payment to the employee.

.05 FAVR allowance limitations.

(1) A FAVR allowance may be paid only to an employee who substantiates to the payor for a calendar year at least 5,000 miles driven in connection with the performance of services as an employee of the employer or, if greater, 80 percent of the annual business mileage of that FAVR allowance. If the employee is covered by the FAVR allowance for less than the entire calendar year, these limits may be prorated on a monthly basis.

(2) A FAVR allowance may not be paid to a control employee (as defined in § 1.61-21(f)(5) and (6), excluding the \$100,000 limitation in paragraph (f)(5)(iii)).

(3) An employer may not pay a FAVR allowance if at any time during a calendar year a majority of the employees covered by the FAVR allowance are management employees.

(4) An employer may not pay a FAVR allowance to any employee unless at all times during a calendar year at least five employees in total are covered by FAVR allowances provided by the employer.

(5) A FAVR allowance may be paid only with respect to an automobile (a) owned or leased by the employee receiving the payment, (b) the cost of which, as a new vehicle (whether or not purchased new by the employee), was at least 90 percent of the standard automobile cost taken into account for purposes of determining the FAVR allowance for the first calendar year the employee receives the allowance with respect to that automobile, and (c) the model year of which does not differ from the current calendar year by more than the number of years in the retention period.

(6) A FAVR allowance may not be paid with respect to an automobile leased by an employee for which the employee has used actual expenses to compute the deductible business expenses of the automobile for any year during the entire lease period. For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(7) The insurance cost component of a FAVR allowance must be based on the rates charged in the base locality for insurance coverage on the standard automobile during the current calendar year without taking into account rate-increasing factors such as poor driving records or young drivers.

(8) A FAVR allowance may be paid only to an employee whose insurance coverage limits on the automobile with respect to which the FAVR allowance is paid are at least equal to the insurance coverage limits used to compute the periodic fixed payment under that FAVR allowance.

.06 Employee reporting. Within 30 days after an employee's automobile is initially covered by a FAVR allowance, or is again covered by a FAVR allowance if coverage has lapsed, the employee by written declaration must provide the payor with the following information: (1) the make, model, and year of the employee's automobile, (2) written proof of the insurance coverage limits on the automobile, (3) the odometer reading of the automobile, (4) if owned, the purchase price of the automobile or, if leased, the price at which the automobile is ordinarily sold by retailers (the gross capitalized cost of the automobile), and (5) if owned, whether the employee has claimed depreciation with respect to the automobile using any of the depreciation methods prohibited by section 8.04(1) of this revenue procedure or, if leased, whether the employee has computed deductible business expenses with respect to the automobile using actual expenses. The information described in (1), (2), and (3) of the preceding sentence also must be supplied by the employee to the payor within 30 days after the beginning of each calendar year that the employee's automobile is covered by a FAVR allowance.

.07 Payor recordkeeping and reporting.

(1) The payor or its agent must maintain written records setting forth (a) the statistical data and projections on which the FAVR allowance payments are based, and (b) the information provided by the employees pursuant to section 8.06 of this revenue procedure.

(2) Within 30 days of the end of each calendar year, the employer must provide each employee covered by a FAVR allowance during that year with a statement that, for automobile owners, lists the amount of depreciation included in each periodic fixed payment portion of the FAVR allowance paid during that calendar year and explains that by receiving a FAVR allowance the employee has elected to exclude the automobile from the Modified Accelerated Cost Recovery System pursuant to § 168(f)(1). For automobile lessees, the statement must explain that by receiving the FAVR allowance the employee may not compute the deductible business expenses of the automobile using actual expenses for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

.08 *Failure to meet section 8 requirements.* If an employee receives a mileage allowance that fails to meet one or more of the requirements of section 8 of this revenue procedure, the employee may not be treated as covered by any FAVR allowance of the payor during the period of the failure. Nevertheless, the expenses to which that mileage allowance relates may be deemed substantiated using the method described in sections 5, 9.01(1), and 9.02 of this revenue procedure to the extent the requirements of those sections are met.

SECTION 9. APPLICATION

.01 If a payor pays a mileage allowance in lieu of reimbursing actual transportation expenses incurred or to be incurred by an employee, the amount of the expenses that is deemed substantiated to the payor is either:

(1) for any mileage allowance other than a FAVR allowance, the lesser of the amount paid under the mileage allowance or the applicable standard mileage rate in section 5.01 of this revenue procedure

multiplied by the number of business miles substantiated by the employee; or

(2) for a FAVR allowance, the amount paid under the FAVR allowance less the sum of (a) any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return to the payor although required to do so, (b) any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return to the payor although required to do so, and (c) any optional high mileage payments.

.02 If the amount of transportation expenses is deemed substantiated under the rules provided in section 9.01 of this revenue procedure, and the employee actually substantiates to the payor the elements of time, place (or use), and business purpose of the transportation expenses in accordance with paragraphs (b)(2) (travel away from home) and (b)(6) (listed property, which includes passenger automobiles and any other property used as a means of transportation) of § 1.274-5T, and paragraph (c) of § 1.274-5, the employee is deemed to satisfy the adequate accounting requirements of § 1.274-5(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274-5(c). See § 1.62-2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.03 An arrangement providing mileage allowances will be treated as satisfying the requirement of § 1.62-2(f)(2) with respect to returning amounts in excess of expenses as follows:

(1) For a mileage allowance other than a FAVR allowance, the requirement to return excess amounts is treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) any portion of the allowance that relates to miles of travel not substantiated by the employee, even though the arrangement does not require the employee to return the portion of the allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance mileage

allowance of \$105.00 based on an anticipated 200 business miles at 52.5 cents per mile (at a time when the business standard mileage rate is 48.5 cents per mile), and the employee substantiates 120 business miles. The requirement to return excess amounts is treated as satisfied if the employee is required to return the portion of the allowance that relates to the 80 unsubstantiated business miles (\$42.00) even though the employee is not required to return the portion of the allowance (\$4.80) that exceeds the amount of the employee's expenses deemed substantiated under section 9.01 of this revenue procedure (\$58.20) for the 120 substantiated business miles. However, the \$4.80 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 9.05.

(2) For a FAVR allowance, the requirement to return excess amounts is treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)), (a) the portion (if any) of the periodic variable payment received that relates to miles in excess of the business miles substantiated by the employee, and (b) the portion (if any) of a periodic fixed payment that relates to a period during which the employee was not covered by the FAVR allowance.

.04 An employee is not required to include in gross income the portion of a mileage allowance received from a payor that is less than or equal to the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02. See § 1.274-5T(f)(2)(i). In addition, that portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W-2, and is exempt from withholding and payment of employment taxes. See § 1.62-2(c)(2) and (c)(4).

.05 An employee is required to include in gross income the portion of a mileage allowance received from a payor that exceeds the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02 of this revenue procedure. See § 1.274-5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or

other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. See § 1.62-2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.06 If an employee's substantiated expenses are less than the employee's actual expenses, the following rules apply:

(1) Except as otherwise provided in section 9.06(2) of this revenue procedure with respect to leased automobiles, if the amount of the expenses deemed substantiated under the rules provided in section 9.01 of this revenue procedure is less than the amount of the employee's business transportation expenses, the employee may claim an itemized deduction for the amount by which the business transportation expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business transportation expenses, includes on Form 2106, *Employee Business Expenses*, the deemed substantiated portion of the mileage allowance received from the payor, and includes in gross income the portion (if any) of the mileage allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274-5T(f)(2)(iii). However, for purposes of claiming this itemized deduction, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the applicable standard mileage rate multiplied by the number of business miles substantiated by the employee minus the amount deemed substantiated under section 9.01 of this revenue procedure. The itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

(2) An employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(1) of this revenue procedure (relating to an allowance other than a FAVR allowance) may not claim a deduction based on actual expenses under section 9.06(1) unless the employee does so consistently beginning with the first business use of the automobile after December 31, 1997. An employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(2) of this revenue procedure (relating to a FAVR allowance) may not claim a deduction based on actual expenses.

.07 An employee may deduct an amount computed pursuant to section 5.01 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.08 A self-employed individual may deduct an amount computed pursuant to section 5.01 of this revenue procedure in determining adjusted gross income under § 62(a)(1).

.09 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, the payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62-2(c)(3), (c)(5), and (h)(2).

SECTION 10. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a mileage allowance (other than a FAVR allowance), if any, that relates to the miles of business travel substantiated and that exceeds the amount deemed substantiated for those miles under section 9.01(1) of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

(1) In the case of a mileage allowance paid as a reimbursement, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the business miles substantiated. See § 1.62-2(h)(2)(i)(B)(2).

(2) In the case of a mileage allowance paid as an advance, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the business miles with respect to which the advance was paid are substantiated. See § 1.62-2(h)(2)(i)(B)(3). If some or all of the business miles with respect to which the advance was paid are not substantiated within a reasonable period

of time and the employee does not return the portion of the allowance that relates to those miles within a reasonable period of time, the portion of the allowance that relates to those miles is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

(3) In the case of a mileage allowance that is not computed on the basis of a fixed amount per mile of travel (for example, a mileage allowance that combines periodic fixed and variable rate payments, but that does not satisfy the requirements of section 8 of this revenue procedure), the payor must compute periodically (no less frequently than quarterly) the amount, if any, that exceeds the amount deemed substantiated under section 9.01(1) of this revenue procedure by comparing the total mileage allowance paid for the period to the standard mileage rate in section 5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee for the period. Any excess is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62-2(h)(2)(i)(B)(4).

(4) For example, assume an employer pays its employees a mileage allowance at a rate of 52.5 cents per mile (when the business standard mileage rate is 48.5 cents per mile). The employer does not require the return of the portion of the allowance that exceeds the business standard mileage rate for the business miles substantiated (4.0 cents). In June, the employer advances an employee \$262.50 for 500 miles to be traveled during the month. In July, the employee substantiates to the employer 400 business miles traveled in June and returns \$52.50 to the employer for the 100 business miles not traveled. The amount deemed substantiated for the 400 miles traveled is \$194.00 and the employee is not required to return \$16.00. No later than the first payroll period following the payroll period in which the 400 business miles traveled are substantiated, the employer must withhold and pay employment taxes on \$16.00.

.02 The portion of a FAVR allowance, if any, that exceeds the amount deemed substantiated for those miles under section 9.01(2) of this revenue procedure is sub-

ject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

(1) Any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return within a reasonable period, or any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return within a reasonable period, is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

(2) Any optional high mileage payment is subject to withholding and payment of employment taxes when paid.

SECTION 11. EFFECTIVE DATE

This revenue procedure is effective for (1) deductible transportation expenses paid or incurred on or after January 1, 2007, and (2) mileage allowances or reimbursements paid to an employee or to a charitable volunteer (a) on or after January 1, 2007, and (b) with respect to transportation expenses paid or incurred by the employee or charitable volunteer on or after January 1, 2007.

SECTION 12. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2005-78 is superseded.

DRAFTING INFORMATION

The principal author of this revenue procedure is John Roman Faron of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Faron at (202) 622-4930 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, § 170.)

Rev. Proc. 2006-50

SECTION 1. PURPOSE

This revenue procedure provides the procedures under which the whaling expenses of an individual recognized by the Alaska Eskimo Whaling Commission (AEWC) as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities are substantiated for purposes of Internal Revenue Code § 170(n), as enacted by the American Jobs Creation Act of 2004 and effective for whaling expenses incurred after December 31, 2004. Pub. L. No. 109-357, § 335.

SECTION 2. BACKGROUND

.01 The AEWC was formed in 1977 to represent the Alaskan whaling communities in efforts to preserve the Eskimo subsistence hunting of bowhead whales (*Baleana mysticetus*). The AEWC's purpose is to protect the bowhead whale and its habitat; preserve Eskimo subsistence bowhead whaling and associated Eskimo culture, traditions, and activities; and conduct research and education activities related to bowhead whales.

.02 The AEWC recognizes certain individuals as whaling captains and provides rules for the conduct of sanctioned whaling activities. It requires these captains to file reports detailing their whaling activities.

.03 Section 170(n) provides that an individual recognized by the AEWC as a whaling captain, who is responsible for maintaining and carrying out sanctioned whaling activities and engages in these activities during the taxable year, may claim a charitable contribution deduction not exceeding \$10,000 per taxable year for the reasonable and necessary whaling expenses paid in carrying out sanctioned whaling activities. Section 170(n) is effective for contributions made after December 31, 2004.

.04 Under § 170(n)(2)(B), "whaling expenses" include amounts paid for (1) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities, (2) the supplying of food for the crew and other provisions

for carrying out sanctioned whaling activities, and (3) the storage and distribution of the catch from sanctioned whaling activities.

.05 Section 170(n)(3) defines "sanctioned whaling activities" as subsistence bowhead whale hunting activities conducted pursuant to the management plan of the AEWC.

.06 Section 170(n)(4) directs the Secretary to issue guidance requiring taxpayers claiming a deduction under § 170(n) to substantiate their whaling expenses by maintaining appropriate written records of the time, place, date, amount, and nature of the expenses and of the taxpayer's eligibility for the deduction.

.07 A whaling captain may deduct an amount for whaling expenses only as an itemized deduction. See § 63(d).

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who are recognized by the AEWC as whaling captains and who pay whaling expenses during the taxable year in carrying out sanctioned whaling activities as captain of a whaling crew.

SECTION 4. SUBSTANTIATION OF EXPENSES

.01 *In general.* A taxpayer within the scope of this revenue procedure is required to substantiate a deduction for whaling expenses by maintaining adequate records of the elements of time, place, date, amount, and nature of the expenses as required under section 4.02, and of the taxpayer's eligibility for the deduction as required under section 4.03, of this revenue procedure.

.02 *Requirements for adequate records of whaling expenses.* A taxpayer within the scope of this revenue procedure must meet each of the following adequate records requirements:

(1) A taxpayer satisfies the adequate records requirement of this revenue procedure by maintaining written records that include—

(A) An expense report (such as an account book, diary, log, statement of expense, trip sheets, or similar record that lists each expense); and

(B) Documentary evidence (such as a receipt, bill, invoice, or credit card record of charge) for each expense of \$75 or more.

(2) Adequate records must document each applicable element of a whaling expense, including the following information:

(A) Time and date of departure and return for each trip for sanctioned whaling activities;

(B) Place or area of sanctioned whaling activities;

(C) Amount of each separate expense, such as the cost of weapons; and

(D) The nature of each expense including a description of the purpose of the expense and the relationship of the expense to sanctioned whaling activities.

(3) The expense report, in combination with the documentary evidence, must be sufficient to establish each element of a whaling expense. It is not necessary to record information in an expense report that duplicates information reflected on documentary evidence (such as a receipt) as long as the expense report and the documentary evidence substantiate each expense in an orderly manner.

(4) Adequate records must be made at or near the time of the expenditure or activity. Records are made at or near the time of the expenditure or activity if information relating to each element (time, place, date, amount, and nature of the expense) is recorded at a time when the taxpayer has full present knowledge of the information.

.03 *Substantiation of eligibility for the deduction.* A taxpayer must substantiate eligibility to deduct whaling expenses under § 170(n) by maintaining documentation that the taxpayer is recognized as a whaling captain by the AEW and copies of all reports the taxpayer submits to the AEW.

.04 *Substantiation under revenue procedure required.* An expense that is not substantiated in accordance with this revenue procedure may not be deducted as a whaling expense under § 170(n). Except as provided in section 5.02 of this revenue procedure, a taxpayer's uncorroborated statement or estimates of expenses unsupported by adequate records do not constitute substantiation for purposes of § 170(n).

SECTION 5. MAINTENANCE OF RECORDS

.01 A taxpayer must maintain with the taxpayer's books and records, and be able to produce upon request of the Internal Revenue Service, the documentation described in section 4 of this revenue procedure. A taxpayer is not required to attach the documentation to the taxpayer's tax return.

.02 Notwithstanding section 4.04 of this revenue procedure, a taxpayer who establishes that a failure to produce adequate records is due to the loss of the records through circumstances beyond the taxpayer's control, such as destruction by fire, flood, earthquake, or other casualty, may substantiate a deduction under § 170(n) by a reasonable reconstruction of the previously-maintained documentation.

SECTION 6. SPECIAL RULES

.01 A taxpayer may not deduct expenses under both § 170(n) and another provision of the Code.

.02 Expenses relating to a whaling boat that is used for sanctioned whaling activities and other activities in a taxable year must be allocated between the sanctioned whaling activities and other activities by comparing the total number of days the whaling boat is used for sanctioned whaling activities to the total number of days in the taxable year.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for whaling expenses paid after November 20, 2006.

SECTION 8. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-2041.

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

The collection of information in this revenue procedure is in sections 4 and 5. This information is required to substantiate the amount of expenses paid in support of native Alaskan subsistence whaling and eligibility to deduct the expenses. This information will be used to substantiate expenses paid during the taxable year in carrying out sanctioned whaling activities upon audit. The collection of information is required to obtain a benefit. The likely respondents are individuals recognized as whaling captains by the AEW.

The estimated total annual recordkeeping burden is 48 hours.

The estimated annual burden per record keeper varies from one to three hours, depending on individual circumstances, with an estimated average of two hours. The estimated number of record keepers is 12 to 24.

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 return information are confidential, as required by § 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is Christian Wood of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Jeffrey Rodrick at (202) 622-4930 (not a toll-free call).

*26 CFR 601.602: Tax forms and instructions.
(Also Part I, § 911.)*

Rev. Proc. 2006-51

SECTION 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 2005-70, 2005-47 I.R.B. 979, which sets forth inflation adjusted items for 2006.

SECTION 2. BACKGROUND

Subject to limitations, section 911 of the Internal Revenue Code allows a qualified individual to elect to exclude from gross income the foreign earned

income and housing cost amount of the individual making the election. Under § 911(b)(2)(D)(i), the foreign earned income exclusion amount is \$80,000 for calendar years after 2001. Prior to amendment by § 515(a) of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345, 367 (2006) (“TIPRA”), § 911(b)(2)(D)(ii) provided for the annual exclusion amount to be adjusted for inflation in any taxable year beginning in a calendar year after 2007. Section 515(a) of TIPRA amended § 911(b)(2)(D)(ii) to provide for the annual exclusion amount to be adjusted for inflation in any taxable year beginning in a calendar year after 2005.

This revenue procedure adds a new subsection to Rev. Proc. 2005-70 to set forth the inflation adjustment for

§ 911(b)(2)(D)(i) in accordance with the amendment made by § 515(a) of TIPRA to § 911(b)(2)(D)(ii).

SECTION 3. AMPLIFICATION OF REV. PROC. 2005-70

Section 3.38 is added to Rev. Proc. 2005-70 to read as follows:

.38 Foreign Earned Income Exclusion. For taxable years beginning in 2006, the foreign earned income exclusion amount under § 911(b)(2)(D)(i) is \$82,400.

SECTION 4. EFFECT ON OTHER DOCUMENTS

This revenue procedure amplifies Rev. Proc. 2005-70 by adding new § 3.38.

SECTION 5. EFFECTIVE DATE

This revenue procedure applies to taxable years beginning in 2006. See § 4.01 of Rev. Proc. 2005-70.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is Marnette M. Myers of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Marnette M. Myers at (202) 622-4920 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Exchanges of Property for an Annuity

REG-141901-05

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that provide guidance on the taxation of the exchange of property for an annuity contract. These regulations are necessary to outline the proper taxation of these exchanges and will affect participants in transactions involving these exchanges. This document also provides notice of public hearing.

DATES: Written or electronic comments must be received by January 16, 2007. Outlines of topics to be discussed at the public hearing scheduled for February 16, 2007, at 10 a.m. must be received by January 16, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-141901-05), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered to CC:PA:LPD:PR (REG-141901-05), Courier's Desk, Internal Revenue Service, Crystal Mall 4 Building, 1901 S. Bell St., Arlington, VA, or sent electronically, via the IRS internet site at www.irs.gov/reg or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-141901-05).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, James Polfer, at (202) 622-3970; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Kelly Banks, at (202) 622-0392 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations.

Section 1001 of the Internal Revenue Code (Code) provides rules for determining the amount of gain or loss recognized. Gain from the sale or other disposition of property equals the excess of the amount realized therefrom over the adjusted basis of the property; loss from the sale or other disposition of property equals the excess of the adjusted basis of the property over the amount realized. Section 1.1001-1(a) of the Income Tax Regulations provides further that the exchange of property for other property differing materially either in kind or in extent is treated as income or as loss sustained. Under section 1001(b), the amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. Except as otherwise provided in the Code, the entire amount of gain or loss on the sale or exchange of property is recognized.

Under section 72(a), gross income includes any amount received as an annuity (whether for a period certain or for the life or lives of one or more individuals) under an annuity, endowment, or life insurance contract. Section 72(b) provides that gross income does not include that part of any amount received as an annuity which bears the same ratio to such amount as the investment in the contract bears to the expected return under the contract. Under section 72(e), amounts received under an annuity contract before the annuity starting date are included in gross income to the extent allocable to income on the contract, and are excluded from gross income to the extent allocable to the investment in the contract. Investment in the contract is defined in section 72(c) as the aggregate amount of premiums or other consideration paid, reduced by amounts received before the annuity starting date that were excluded from gross income.

In *Lloyd v. Commissioner*, 33 B.T.A. 903 (1936), *nonacq.*, XV-2 C.B. 39

(1936), *nonacq. withdrawn and acq.*, 1950-2 C.B. 3, the Board of Tax Appeals considered the taxation of gain from a father's sale of property to his son for an annuity contract. The Board concluded that the annuity contract had no fair market value within the meaning of the predecessor of section 1001(b) because of the uncertainty of payment from the son. Because the annuity contract had no fair market value under that provision, the Board held that the gain from the sale of the property was not required to be recognized immediately but rather would be included in income only when the annuity payments exceeded the property's basis. In reaching its holding, the Board applied the open transaction doctrine articulated by the Supreme Court in *Burnet v. Logan*, 283 U.S. 404 (1931). Under this doctrine, if an amount realized from a sale cannot be determined with certainty, the seller recovers the basis of the property sold before any income is realized on the sale.

In Rev. Rul. 69-74, 1969-1 C.B. 43, a father transferred a capital asset having an adjusted basis of \$20,000 and a fair market value of \$60,000 to his son in exchange for the son's legally enforceable promise to pay him a life annuity of \$7,200 per year, in equal monthly installments of \$600. The present value of the life annuity was \$47,713.08. The ruling concluded that: (1) the father realized capital gain based on the difference between the father's basis in the property and the present value of the annuity; (2) the gain was reported ratably over the father's life expectancy; (3) the investment in the contract for purposes of computing the exclusion ratio was the father's basis in the property transferred; (4) the excess of the fair market value of the property transferred over the present value of the annuity was a gift from the father to the son; and (5) the prorated capital gain reported annually was derived from the portion of each annuity payment that was not excludible.

In *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973), *acq. in part and nonacq. in part*, 1974 WL 36039 (Jan. 8, 1974), *acq.*, AOD No. 1979-184 (August 15, 1979), a husband and wife transferred stock in two closely held corporations to their son and daughter and their spouses

in exchange for an annuity contract. The fair market value of the stock substantially exceeded the value of the annuity contract. The stock transferred was placed in escrow to secure the promise of the transferees. As further security, the annuity agreement provided for a cognovit judgment against the transferees in the event of default. Because of the secured nature of the annuity, the tax court held that (i) the difference between the value of the stock and the value of the annuity contract constituted a gift; (ii) the difference between the adjusted basis of the stock and the value of the annuity contract constituted gain that was taxable in the year of the transfer (which was not before the court); and (iii) the investment in the annuity contract equaled the present value of the annuity. Similarly, in *212 Corp. v. Commissioner*, 70 T.C. 788 (1978), the tax court held that the entire amount of gain realized from the exchange of appreciated real property for an annuity contract was fully taxable in the year of the exchange because the annuity contract was secured by (i) an agreement that the annuity payments would be considered a charge against the rents from the property, (ii) an agreement not to mortgage or sell the property without written consent of the transferors, and (iii) the authorization of a confession of judgment against the transferee in the event of default.

The Treasury Department and the IRS have learned that some taxpayers are inappropriately avoiding or deferring gain on the exchange of highly appreciated property for the issuance of annuity contracts. Many of these transactions involve private annuity contracts issued by family members or by business entities that are owned, directly or indirectly, by the annuitants themselves or by their family members. Many of these transactions involve a variety of mechanisms to secure the payment of amounts due under the annuity contracts.

The Treasury Department and the IRS believe that neither the open transaction approach of *Lloyd v. Commissioner* nor the ratable recognition approach of Rev. Rul. 69-74 clearly reflects the income of the transferor of property in exchange for an annuity contract. Contrary to the premise underlying these authorities, an annuity contract — whether secured or unsecured — may be valued at the time it is received in exchange for property. See generally

section 7520 (requiring the use of tables to value any annuity contract for federal income tax purposes, except for purposes of any provision specified in regulations); §1.1001-1(a) (“The fair market value of property is a question of fact, but only in rare and unusual circumstances will property be considered to have no fair market value.”). The Treasury Department and the IRS believe that the transferors should be taxed in a consistent manner regardless of whether they exchange property for an annuity or sell that property and use the proceeds to purchase an annuity.

Explanation of Provisions

These proposed amendments provide that, if an annuity contract is received in exchange for property (other than money), (i) the amount realized attributable to the annuity contract is the fair market value (as determined under section 7520) of the annuity contract at the time of the exchange; (ii) the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer’s method of accounting; and (iii) for purposes of determining the initial investment in the annuity contract under section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (the fair market value of the annuity contract). Thus, in situations where the fair market value of the property exchanged equals the fair market value of the annuity contract received, the investment in the annuity contract equals the fair market value of the property exchanged for the annuity contract.

In order to apply the proposed regulations to an exchange of property for an annuity contract, taxpayers will need to determine the fair market value of the annuity contract as determined under section 7520. In the case of an exchange of property for an annuity contract that is in part a sale and in part a gift, the proposed regulations apply the same rules that apply to any other such exchange under section 1001.

The proposed regulations provide that, for purposes of determining the investment in the annuity contract under section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract is the portion of the amount

realized on the exchange that is attributable to the annuity contract (which is the fair market value of the annuity contract at the time of the exchange). This rule is intended to ensure that no portion of the gain or loss on the exchange is duplicated or omitted by the application of section 72 in the years after the exchange. The annuitant’s investment in the contract would be reduced in subsequent years under section 72(c)(1)(B) for amounts already received under the contract subsequent to the exchange and excluded from gross income when received as a return of the annuitant’s investment in the contract.

The proposed regulations do not distinguish between secured and unsecured annuity contracts, or between annuity contracts issued by an insurance company subject to tax under subchapter L and those issued by a taxpayer that is not an insurance company. Instead, the proposed regulations provide a single set of rules that leave the transferor and transferee in the same position before tax as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract. The same rules would apply whether the exchange produces a gain or loss. The regulations do not, however, prevent the application of other provisions, such as section 267, to limit deductible losses in the case of some exchanges. The proposed regulations apply to exchanges of property for an annuity contract, regardless of whether the property is exchanged for a newly issued annuity contract or whether the property is exchanged for an already existing annuity contract.

Existing regulations in §1.1011-2 govern the tax treatment of an exchange of property that constitutes a bargain sale to a charitable organization (including an exchange of property for a charitable gift annuity). Example 8 in section 2(c) of those regulations provides that any gain on such an exchange is reported ratably, rather than entirely in the year of the exchange. This notice of proposed rulemaking does not propose to change the existing regulations in §1.1011-2. However, comments are requested as to whether a change should be made in the future to conform the tax treatment of exchanges governed by §1.1011-2 to the tax treatment prescribed in these proposed regulations.

The Treasury Department and the IRS are aware that property is sometimes ex-

changed for an annuity contract, including a private annuity contract, for valid, non-tax reasons related to estate planning and succession planning for closely held businesses. The proposed regulations are not intended to frustrate these transactions, but will ensure that income from the transactions is accounted for in the appropriate periods. In section 453, Congress set forth rules permitting the deferral of income from a transaction that qualifies as an installment sale. Taxpayers retain the ability to structure transactions as installment sales within the meaning of section 453(b), provided the other requirements of section 453 are met. The Treasury Department and IRS request comments as to the circumstances, if any, in which an exchange of property for an annuity contract should be treated as an installment sale, and as to any changes to the regulations under section 453 that might be advisable with regard to those circumstances.

Proposed Effective Date

The Treasury Department and the IRS propose §1.1001-1(j) to be effective generally for exchanges of property for an annuity contract after October 18, 2006. Thus, the regulations would not apply to amounts received after October 18, 2006, under annuity contracts that were received in exchange for property before that date. For a limited class of transactions, however, §1.1001-1(j) is proposed to be effective for exchanges of property for an annuity contract after April 18, 2007.

The Treasury Department and the IRS propose §1.72-6(e) to be effective generally for annuity contracts received in such exchanges after October 18, 2006. For a limited class of transactions, however, §1.72-6(e) is proposed to be effective for annuity contracts received in exchange for property after April 18, 2007. The Treasury Department and the IRS also propose to declare Rev. Rul. 69-74 obsolete effective contemporaneously with the effective date of these regulations. Thus, the obsolescence would be effective April 18, 2007, for exchanges described in §1.1001-1(j)(2)(ii) and §1.72-6(e)(2)(ii), and effective October 18, 2006, for all other exchanges of property for an annuity contract.

In both regulations, the effective date is delayed for six months for transactions in

which (i) the issuer of the annuity contract is an individual; (ii) the obligations under the annuity contract are not secured, either directly or indirectly; and (iii) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. The Treasury Department and the IRS believe that the later proposed effective date for these transactions provides ample notice of the proposed rules for taxpayers currently planning transactions that present the least opportunity for abuse.

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 these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulation flexibility analysis is not required. This certification is based on the fact that typically only natural persons within the meaning of section 72(u) exchange property for an annuity contract. In addition, these regulations do not impose new reporting, recordkeeping, or other compliance requirements on taxpayers. Pursuant to section 7805(f) of the Code, the 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 (a signed original and eight (8) copies) or electronic comments that are timely submitted to the IRS. In addition to comments on the proposed regulations more generally, the Treasury Department and the IRS specifically request comments on (i) the clarity of the proposed regulations and how they can be made easier to understand; (ii) what guidance, if any, is needed in addition to Rev. Rul. 55-119, 1955-1 C.B. 352, see §601.601(d)(2), on the treatment of the issuer of an annuity contract that is not taxed under the provisions of subchapter L of the Code; (iii) whether any changes

to §1.1011-2 (concerning a bargain sale to a charitable organization in exchange for an annuity contract), conforming those regulations to the proposed regulations, would be appropriate; (iv) circumstances (and corresponding changes to the regulations under section 453, if any) in which it might be appropriate to treat an exchange of property for an annuity contract as an installment sale; (v) circumstances, if any, in which the fair market value of an annuity contract for purposes of §1.1001-1(j) should be determined other than by tables promulgated under the authority of section 7520; and (vi) additional transactions, if any, for which the six month delayed effective date would be appropriate. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 16, 2007, at 10 a.m., in the auditorium, Internal Revenue Service, New Carrollton Building, 5000 Ellin Road, Lanham, MD 20706. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area lobby more than 30 minutes before the hearing starts. For information about having your name placed on the 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 at the hearing must submit written comments by January 16, 2007, and submit 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 that same date.

A period of 10 minutes will be allotted to each person making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is James Polfer, Office of the Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service.

* * * * *

Proposed Amendment to the Regulations

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

PART 1—INCOME TAX

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

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

Par. 2. In §1.72–6, paragraph (e) is added to read as follows:

§1.72–6 *Investment in the contract.*

* * * * *

(e) *Certain annuity contracts received in exchange for property* — (1) *In general.* If an annuity contract is received in an exchange subject to §1.1001–1(j), the aggregate amount of premiums or other consideration paid for the contract equals the amount realized attributable to the annuity contract, determined according to §1.1001–1(j).

(2) *Effective date* — (i) *In general.* Except as provided in paragraph (e)(2)(ii), this paragraph (e) is applicable for annuity contracts received after October 18, 2006, in an exchange subject to §1.1001–1(j).

(ii) This paragraph (e) is applicable for annuity contracts received after April 18, 2007, in an exchange subject to §1.1001–1(j) if the following conditions are met —

(A) The issuer of the annuity contract is an individual;

(B) The obligations under the annuity contract are not secured, either directly or indirectly; and

(C) The property transferred in exchange for the annuity contract is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. For purposes of this provision, a disposition includes without limitation a transfer to a trust (whether a grantor trust, a revocable trust, or any other trust) or to any other entity even if solely owned by the transferor.

Par. 3. In §1.1001–1, paragraphs (h), (i) and (j) are added to read as follows:

§1.1001–1 *Computation of gain or loss.*

* * * * *

(h) [Reserved.]

(i) [Reserved.]

(j) *Certain annuity contracts received in exchange for property* — (1) *In general.* If an annuity contract (other than an annuity contract that either is a debt instrument subject to sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011–2) is received in exchange for property, receipt of the contract shall be treated as a receipt of property in an amount equal to the fair market value of the contract, whether or not the contract is the equivalent of cash. The amount realized attributable to the annuity contract is the fair market value of the annuity contract at the time of the exchange, determined under section 7520. For the timing of the recognition of gain or loss, if any, see §1.451–1(a). In the case of a transfer in part a sale and in part a gift, see paragraph (e) of this section. In the case of an annuity contract that is a debt instrument subject to sections 1271 through 1275, see paragraph (g) of this section. In the case of a bargain sale to a charitable organization, see §1.1011–2.

(2) *Effective date* — (i) *In general.* Except as provided in paragraph (j)(2)(ii), this paragraph (j) is effective for exchanges of property for an annuity contract (other than an annuity contract that either is a debt instrument subject to sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011–2) after October 18, 2006.

(ii) This paragraph (j) is effective for exchanges of property for an annuity contract (other than an annuity contract that either is a debt instrument subject to sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011–2) after April 18, 2007, if the following conditions are met —

(A) The issuer of the annuity contract is an individual;

(B) The obligations under the annuity contract are not secured, either directly or indirectly; and

(C) The property transferred in exchange for the annuity contract is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. For purposes of this provision, a disposition includes without limitation a transfer to a trust (whether a grantor trust,

a revocable trust, or any other trust) or to any other entity even if solely owned by the transferor.

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

(Filed by the Office of the Federal Register on October 17, 2006, 8:45 a.m., and published in the issue of the Federal Register for October 18, 2006, 71 F.R. 61441)

Notice of Proposed Rulemaking and Notice of Public Hearing

Treatment of Payments in Lieu of Taxes Under Section 141

REG–136806–06

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations modifying the standards for treating payments in lieu of taxes (PILOTs) as generally applicable taxes for purposes of the private security or payment test under section 141 of the Internal Revenue Code (Code). The proposed regulations provide State and local governmental issuers of tax-exempt bonds with guidance for applying the private security or payment test. The proposed regulations affect State and local governmental issuers of tax-exempt bonds. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 16, 2007. Outlines of topics to be discussed at the public hearing scheduled for February 13, 2007, at 10 a.m., must be received by January 16, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–136806–06), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered to CC:PA:LPD:PR (REG–136806–06), Courier's Desk, Internal Revenue Service, Crystal Mall 4 Building, 1901 S. Bell Street, Arlington, Virginia, or sent

electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRule-making Portal at www.regulations.gov (IRS REG-136806-06). The public hearing will be held in the auditorium, Internal Revenue Service, New Carrollton Federal Building, 5000 Ellin Road, Lanham, Maryland 20706.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Vicky Tsilas or Carla Young, at (202) 622-3980; concerning submissions of comments, the hearing and/or to be placed on the building access list to attend the hearing, Kelly Banks, at (202) 622-0392 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1). Final regulations (T.D. 8712, 1997-12 I.R.B. 4) under section 141 of the Code were published in the **Federal Register** on January 16, 1997 (62 FR 2275) to provide comprehensive guidance on most aspects of the private activity bond restrictions. This document amends the Income Tax Regulations under section 141 of the Code by proposing modifications to the standards for treating payments in lieu of taxes as generally applicable taxes for purposes of the private security or payment test under section 141. These regulations are published as proposed regulations to provide an opportunity for public review and comment.

Explanation of Provisions

I. Introduction.

In general, interest on State and local governmental bonds is excludable from gross income under section 103 of the Code. Interest on a private activity bond, other than a qualified bond under section 141(e), is not excludable from gross income. Section 141(a) classifies a bond as a private activity bond if it is part of an issue that meets both the private business use test under section 141(b)(1) (the private business use test) and the private security or payment test under section 141(b)(2) (the private payment test). In addition,

section 141(a) independently treats a bond as a private activity bond if it is part of an issue that meets the private loan test under section 141(c).

Section 141(b)(2) provides generally that an issue meets the private payment test if the payment of the debt service on more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly (1) secured by any interest in property used or to be used for a private business use, or payments in respect of such property, or (2) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

II. Private Payment Test in General.

Sections 1.141-4(c) and 1.141-4(d) of the Income Tax Regulations provide broad general rules for purposes of application of the private payment test. Private payments generally include any payments made, directly or indirectly, by any nongovernmental person that is a private business user of proceeds during a period of private business use and any payments made with respect to property financed with proceeds of an issue during a period of private business use, whether or not made by a private business user. In addition, private payments include property and payments in respect of property that are used or to be used for private business use to the extent that any interest in that property or payments serves as security for the payment of debt service on an issue.

III. Generally Applicable Taxes Exception.

Section 1.141-4(e) provides an exception to the otherwise-broad scope of payments taken into account under the private payment test in the case of “generally applicable taxes.” In general, the purpose of the generally applicable taxes exception is to allow eligible tax payments made with respect to property or services to be used to pay debt service on an issue without causing private payments. For this purpose, §1.141-4(e)(2) defines a generally applicable tax to mean an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected

for the purpose of raising revenue to be used for governmental purposes. To qualify as a generally applicable tax, a tax must have a uniform rate that is applied to all persons of the same classification in the appropriate jurisdiction and the tax must have a generally applicable manner of determination and collection. By contrast, under §1.141-4(e)(3), a payment does not qualify as a generally applicable tax if it is a special charge for a special privilege granted or service rendered (for example, a payment limited to property or persons benefited by an improvement). Sections 1.141-4(e)(4)(ii) and (iii) set forth certain permissible and impermissible agreements that bear upon whether or not a tax has a generally applicable manner of determination and collection. For example, an agreement to reduce or limit the amount of taxes collected to further a *bona fide* governmental purpose is a permissible agreement.

IV. Certain Payments in Lieu of Taxes Treated as Generally Applicable Taxes.

In addition, existing §1.141-4(e)(5) treats certain tax equivalency payments or PILOTs as generally applicable taxes if (1) the payments are commensurate with and not greater than the amounts imposed by the statute for a tax of general application, and (2) the payments are designated for a public purpose and are not special charges (as described in §1.141-4(e)(3)). Existing §1.141-4(e)(5) further provides an example which states that a PILOT made in consideration for the use of property financed with tax-exempt bonds is treated as a special charge.

The Treasury Department and the IRS are concerned that additional guidance may be needed regarding the existing standards for treating PILOTs as generally applicable taxes and that those existing standards potentially could be interpreted in an unduly broad manner to provide favorable treatment for certain PILOTs which may have an insufficient link to generally applicable taxes. Conversely, the Treasury Department and the IRS are concerned that the last sentence of existing §1.141-4(e)(5)(ii), which provides as an example of a special charge a PILOT paid in consideration for the use of property financed with tax-exempt bonds, could be interpreted in an unduly restrictive manner to prevent any PILOTs with respect to

property financed with tax-exempt bonds from being treated as generally applicable taxes.

To address these concerns, the Treasury Department and the IRS propose to modify the standards to better assure a reasonably close relationship between eligible PILOT payments and generally applicable taxes. The proposed clarification provides that an eligible PILOT payment must represent a fixed percentage of, or reflect a fixed adjustment to, the amount of generally applicable taxes in each year, based on comparable current valuation assessments. In addition, the Treasury Department and the IRS propose to eliminate the example in the last sentence of §1.141-4(e)(5)(ii). Regarding this latter proposal, the Treasury Department and the IRS believe that the existing definition of special charge under §1.141-4(e)(3) adequately addresses this principle.

The proposed standards for treating PILOTs as generally applicable taxes generally contemplate PILOTs based on property taxes. The Treasury Department and the IRS also seek public comment regarding whether any special rules are needed to address PILOTs based on other taxes, including sales taxes.

Proposed Effective Date

The proposed regulations are proposed to apply to bonds that are sold on or after February 16, 2007.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedures 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, this proposed regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for February 13, 2007, at 10 a.m. in the auditorium of the Internal Revenue Service, New Carrollton Federal Building, 5000 Ellin Road, Lanham, Maryland 20706. Due to building security procedures, visitors must enter at the New Carrollton Federal Building main entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the amount of time to be devoted to each topic (signed original and eight (8) copies) by January 16, 2007. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Rebecca L. Harrigal, Vicky Tsilas, and Carla Young, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 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 1.141-4(e)(5) is revised to read as follows:

§1.141-4 Private Security or Payment Test.

* * * * *

(e) * * *

(5) *Payments in lieu of taxes*—(i) *In general.* A tax equivalency payment or other payment in lieu of a tax (PILOT) is treated as a generally applicable tax if—

(A) The payment is commensurate with and not greater than the amounts imposed by a statute for a generally applicable tax in each year; and

(B) The payment is designated for a public purpose and is not a special charge (as described in paragraph (e)(3) of this section).

(ii) *Commensurate standard.* For purposes of this paragraph (e)(5), a payment is "commensurate" with generally applicable taxes only if the amount of such payment represents a fixed percentage of, or reflects a fixed adjustment to, the amount of generally applicable taxes that otherwise would apply to the property in each year if the property were subject to tax. For example, a payment is commensurate with generally applicable taxes if it is equal to the amount of generally applicable taxes in each year, less a fixed dollar amount or a fixed adjustment determined by reference to characteristics of the property, such as size or employment. A payment does not fail to be a fixed percentage or adjustment as a result of a single change in the level of the percentage or adjustment following completion of development of the subject property. The payment must be based on the current assessed value of the property for property tax purposes for each year in which the PILOTs are paid and that assessed value must be determined in the same manner and with the same frequency as property subject to generally applicable taxes. A payment is not commensurate if

it is based in any way on debt service on an issue or is otherwise set at a fixed dollar amount that cannot vary with the assessed value of the property determined in the manner described in this paragraph (e)(5)(ii).

* * * * *

Par. 3. Section 1.141-15 is amended by adding paragraph (m) to read as follows:

§1.141-15 Effective Dates.

* * * * *

(m) *Effective date for certain regulations relating to payments in lieu of tax.* The rules of §1.141-4(e)(5) apply to bonds sold on or after [DATE THAT IS 120 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE **Federal Register**] that are subject to section 141.

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

(Filed by the Office of the Federal Register on October 18, 2006, 8:45 a.m., and published in the issue of the Federal Register for October 19, 2006, 71 F.R. 61693)

Definition of Taxpayer for Purposes of Section 901 and Related Matters; Correction

Announcement 2006-90

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains corrections to notice of proposed rulemaking and notice of public hearing (REG-124152-06, 2006-36 I.R.B. 368) that was published in the **Federal Register** on Friday, August 4, 2006 (71 FR 44240) relating to the determination of who is considered to pay a foreign tax for purposes of sections 901 and 903.

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

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking and notice of public hearing (REG-124152-06) that is the subject of these corrections are under sections 901 and 903 of the Internal Revenue Code.

Need for Correction

As published, the notice of proposed rulemaking and notice of public hearing (REG-124152-06) contains errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the notice of proposed rulemaking and notice of public hearing (REG-124152-06) that was the subject of FR Doc. E6-12358 is corrected as follows:

§1.901-2 [Corrected]

1. On page 44246, column 1, §1.901-2(f)(6), paragraph (i) of *Example 4.*, line 4, the language “county Y. A accrues interest income on the” is corrected to read “country Y. A accrues interest income on the”.

2. On page 44246, column 2, §1.901-2(f)(6), paragraph (i) of *Example 4.*, first paragraph of the column, line 1, the language “pay over to country X 10 percent of the” is corrected to read “pay over to country Y 10 percent of the”.

3. On page 44247, column 1, §1.901-2(f)(6), paragraph (i) of *Example 8.*, the language “tax purposes. New D also has a short U.S.” is corrected to read “tax purposes. “New” D also has a short U.S.”.

4. On page 44247, column 1, §1.901-2(f)(6), paragraph (ii) of *Example 8.*, line 11, the language “years of terminating D and new D. See” is corrected to read “years of old D and new D. See”.

5. On page 44247, column 1, §1.901-2(f)(6), paragraph (ii) of *Example 8.*, line 13, the language “allocation of terminating D’s country M taxes” is corrected to read “allocation of old D’s country M taxes”.

6. On page 44247, column 1, §1.901-2(h), the language “(h) *Effective Date.* Paragraphs (a)” is corrected to read “(h) *Effective date.* Paragraphs (a)”.

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

(Filed by the Office of the Federal Register on October 30, 2006, 8:45 a.m., and published in the issue of the Federal Register for October 31, 2006, 71 F.R. 63732)

Determination of Basis of Stock or Securities Received in Exchange for, or With Respect to, Stock or Securities in Certain Transactions; Treatment of Excess Loss Accounts; Correction

Announcement 2006-91

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains a correction to final and temporary regulations (T.D. 9244, 2006-8 I.R.B. 463), that were published in the **Federal Register** on Thursday, January 26, 2006 (71 FR 4264). This regulation provides guidance regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions.

DATES: This correction is effective January 23, 2006.

FOR FURTHER INFORMATION CONTACT: Theresa M. Kolish, (202) 622-7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final and temporary regulations (T.D. 9244) that are the subject of these

corrections are under sections 358 and 1502 of the Internal Revenue Code.

Need for Correction

As published, T.D. 9244 contains errors that may prove to be misleading and are in need of clarification.

* * * * *

Correction of Publication

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

PART 1—INCOME TAXES

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

Authority: 26 USC 7805 * * * *

§1.358-1 [Corrected]

Par. 2. Section 1.358-1 is amended by revising paragraph (b), *Example* to read as follows:

§1.358-1 Basis to distributees.

(a) * * *

(b) * * *

Example. A purchased a share of stock in Corporation X in 1935 for \$150. Since that date A has received distributions out of other than earnings and profits (as defined in section 316) totaling \$60, so that A's adjusted basis for the stock is \$90. In a transaction qualifying under section 356, A exchanged this share for one share in Corporation Y, worth \$100, cash in the amount of \$10, and other property with a fair market value of \$30. The exchange had the effect of the distribution of a dividend. A's ratable share of the earnings and profits of Corporation X accumulated after February 28, 1913, was \$5. A realized a gain of \$50 on the exchange, but the amount recognized is limited to \$40, the sum of the cash received and the fair market value of the other property. Of the gain recognized, \$5 is taxable as a dividend, and \$35 is taxable as a gain from the exchange of property. The basis to A of the one share of stock of Corporation Y is \$90, that is, the adjusted basis of the one share of stock of Corporation X (\$90), decreased by the sum of the cash received (\$10) and the fair market value of the other property received (\$30) and increased by the sum of the amount treated as a dividend (\$5) and the amount treated as a gain from the exchange of property (\$35). The basis of the other property received is \$30.

* * * * *

§1.358-2 [Corrected]

Par. 3. Section 1.358-2(c) is amended by revising paragraphs (ii) in *Examples 4, 5, 6 and 11* to read as follows:

§1.358-2 Allocation of basis among nonrecognition property.

(a) * * *

(2) * * *

(viii) * * *

(c) * * *

Example 4. (i) * * *

(ii) *Analysis.* Under paragraph (a)(2)(ii) of this section and under §1.356-1(b), because the terms of the exchange do not specify that shares of Corporation Y stock or cash are received in exchange for particular shares of Class A stock or Class B stock of Corporation X, a *pro rata* portion of the shares of Corporation Y stock and cash received will be treated as received in exchange for each share of Class A stock and Class B stock of Corporation X surrendered based on the fair market value of such stock. Therefore, J is treated as receiving one share of Corporation Y stock and \$5 of cash in exchange for each share of Class A stock of Corporation X and one share of Corporation Y stock and \$5 of cash in exchange for each share of Class B stock of Corporation X. J realizes a gain of \$140 on the exchange of shares of Class A stock of Corporation X, \$100 of which is recognized under §1.356-1(a). J realizes a gain of \$80 on the exchange of Class B stock of Corporation X, all of which is recognized under §1.356-1(a). Under paragraph (a)(2)(i) of this section, J has 10 shares of Corporation Y stock, each of which has a basis of \$2 and is treated as having been acquired on Date 1, 10 shares of Corporation Y stock, each of which has a basis of \$4 and is treated as having been acquired on Date 2, and 20 shares of Corporation Y stock, each of which has a basis of \$5 and is treated as having been acquired on Date 3. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock received have a basis of \$2, which have a basis of \$4, and which have a basis of \$5.

Example 5. (i) * * *

(ii) *Analysis.* Under paragraph (a)(2)(ii) of this section and under §1.356-1(b), because the terms of the exchange specify that J receives 40 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and \$200 of cash in exchange for J's shares of Class B stock of Corporation X and such terms are economically reasonable, such terms control. J realizes a gain of \$140 on the exchange of shares of Class A stock of Corporation X, none of which is recognized under §1.356-1(a). J realizes a gain of \$80 on the exchange of shares of Class B stock of Corporation X, all of which is recognized under §1.356-1(a). Under paragraph (a)(2)(i) of this section, J has 20 shares of Corporation Y stock, each of which has a basis of \$1 and is treated as having been acquired on Date 1, and 20 shares of Corporation Y stock, each of which has a basis of \$2 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before

the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock received have a basis of \$1 and which have a basis of \$2.

Example 6. (i) * * *

(ii) *Analysis.* Under paragraph (a)(2)(ii) of this section and under §1.354-1(a), because the terms of the exchange specify that J receives 10 shares of stock of Corporation Y in exchange for J's shares of Class A stock of Corporation X and a Corporation Y security in exchange for its Corporation X security and such terms are economically reasonable, such terms control. Pursuant to section 354, J recognizes no gain on either exchange. Under paragraph (a)(2)(i) of this section, J has 10 shares of Corporation Y stock, each of which has a basis of \$2 and is treated as having been acquired on Date 1, and a security that has a basis of \$100 and is treated as having been acquired on Date 2.

* * * * *

Example 11. (i) * * *

(ii) *Analysis.* Under paragraph (a)(2)(iii) of this section, J is deemed to have received shares of Corporation Y stock with an aggregate fair market value of \$1,000 in exchange for J's Corporation X shares. Consistent with the economics of the transaction and the rights associated with each class of stock of Corporation Y owned by J, J is deemed to receive additional shares of Corporation Y common stock. Because the value of the common stock indicates that the liquidation preference associated with the Corporation Y preferred stock could be satisfied even if the reorganization did not occur, it is not appropriate to deem the issuance of additional Corporation Y preferred stock. Given the number of outstanding shares of common stock of Corporation Y and their value immediately before the effective time of the reorganization, J is deemed to have received 100 shares of common stock of Corporation Y in the reorganization. Under paragraph (a)(2)(i) of this section, each of those shares has a basis of \$1 and is treated as having been acquired on Date 1. Then, the common stock of Corporation Y is deemed to be recapitalized in a reorganization under section 368(a)(1)(E) in which J receives 100 shares of Corporation Y common stock in exchange for those shares of Corporation Y common stock that J held immediately prior to the reorganization and those shares of Corporation Y common stock that J is deemed to have received in the reorganization. Under paragraph (a)(2)(i), immediately after the reorganization, J holds 50 shares of Corporation Y common stock, each of which has a basis of \$2 and is treated as having been acquired on Date 1, and 50 shares of Corporation Y common stock, each of which has a basis of \$4 and is treated as having been acquired on Date 2. Under paragraph (a)(2)(vii) of this section, on or before the date on which the basis of any share of J's Corporation Y common stock becomes relevant, J may designate which of those shares have a basis of \$2 and which have a basis of \$4.

* * * * *

§1.1502-19T [Corrected]

Par. 4 Section 1.1502-19T is amended by removing the cross-reference for para-

graphs (b) through (c) and adding a cross-reference for paragraphs (a) through (c) and revising the text of (h)(2)(iv) to read as follows:

§1.1502-19T Excess loss accounts (temporary).

(a) through (c) [Reserved]. For further guidance, see §1.1502-19 (a) through (c).

(h)(2)(iv) *** For guidance regarding determinations of the basis of the stock of a subsidiary acquired in an intercompany reorganization on or after January 23, 2006, see paragraphs (d) and (g) *Example 2* of this section.

§1.1502-32 [Corrected]

Par. 5. Section 1.1502-32 is amended by revising the text of paragraph (h)(8) to read as follows:

§1.1502-32 Investment adjustments.

(h) ***

(h)(8) *** Paragraph (b)(5)(ii) *Example 6* of this section applies only with respect to determinations of the basis of the stock of a subsidiary on or after January 23, 2006. For determinations of the basis of the stock of a subsidiary before January

23, 2006, see §1.1502-32(b)(5)(ii) *Example 6* as contained in the 26 CFR part 1 edition revised as of April 1, 2005.

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(Filed by the Office of the Federal Register on October 25, 2006, 8:45 a.m., and published in the issue of the Federal Register for October 26, 2006, 71 F.R. 62556)

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.

ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.

PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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