Internal Revenue bulletin

Bulletin No. 2007-14
April 2, 2007

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2007–19, page 843.

Frivolous tax returns; wages not taxable income. This ruling discusses and refutes the frivolous position taken by some taxpayers that wages are not taxable income.

Rev. Rul. 2007–20, page 863.

Frivolous tax returns; voluntary compliance. This ruling discusses and refutes the frivolous position taken by some taxpayers that complying with the internal revenue laws is purely voluntary and that taxpayers are not legally required to file federal tax returns or pay federal tax because the filing of a tax return or the payment of tax is a matter of choice.

Rev. Rul. 2007–21, page 865.

Frivolous tax returns; summary record of assessment. This ruling discusses and refutes the frivolous position taken by some taxpayers that before the IRS may collect overdue taxes, the IRS must provide taxpayers with a summary record of assessment made on a Form 23C, *Assessment Certificate-Summary Record of Assessments*, or on another particular form. These taxpayers claim that if a Form 23C is not provided, the assessment is invalid and the IRS may not collect any taxes due.

Rev. Rul. 2007–22, page 866.

Frivolous tax returns; citizens of a state. This ruling discusses and refutes the frivolous position taken by some taxpayers that they are not subject to federal income tax, or that their income is excluded from taxation, because either (1) they claim to have rejected or renounced United States citizenship and are citizens exclusively of a state (sometimes characterized as a "natural-born citizen" of a "sovereign state"), or (2) they are not persons as identified by the Internal Revenue Code.

T.D. 9314, page 845.

Final regulations under section 168 of the Code relate to the depreciation of property subject to the accelerated cost recovery system (MACRS property). The regulations provide guidance on how to depreciate MACRS property acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033 when both the acquired and relinquished property are subject to MACRS in the hands of the acquiring taxpayer.

Notice 2007–26, page 870.

This notice solicits applications for allocation of the available volume cap for clean renewable energy bonds (CREBs) under section 54 of the Code. The notice also provides guidance on the CREB program requirements, volume cap allocation method, and certain aspects of applicable law regarding CREBs. Notice 2005–98 modified and superseded.

Notice 2007–29, page 881.

Request for comments and interim guidance regarding allocation of costs under the simplified methods of accounting under section 263A. This notice invites public comment on changes to the simplified production method under regulations section 1.263A–2(b) and the simplified resale method under regulations section 1.263A–3(d). Pending the issuance of additional published guidance, the Service will not challenge the inclusion of negative amounts in computing additional costs under section 263A of the Code or the permissibility of aggregate negative additional section 263A costs.

Notice 2007–30, page 883.

This notice lists positions identified as frivolous for purposes of section 6702(c) of the Code.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EMPLOYEE PLANS

Notice 2007–28, page 880.
Deductibility; contributions; sections 801 and 803 of the Pension Protection Act of 2006. This notice addresses, in question and answer format, the deductibility of certain contributions to qualified defined benefit pension plans under section 404(a)(1) of the Code and the deductibility of certain contributions to a combination of plans under section 404(a)(7).

EXEMPT ORGANIZATIONS

Notice 2007–30, page 883.
This notice lists positions identified as frivolous for purposes of section 6702(c) of the Code.

Rev. Proc. 2007–27, page 887.
This procedure sets forth the elements of a safe harbor under section 527(1) of the Code for waiver of amounts due for failure to comply with certain reporting requirements due to reasonable cause but not willful neglect.

ESTATE TAX

Rev. Rul. 2007–20, page 863.
Frivolous tax returns; voluntary compliance. This ruling discusses and refutes the frivolous position taken by some taxpayers that complying with the internal revenue laws is purely voluntary and that taxpayers are not legally required to file federal tax returns or pay federal tax because the filing of a tax return or the payment of tax is a matter of choice.

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GIFT TAX

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SELF-EMPLOYMENT TAX

Rev. Rul. 2007–20, page 863.
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EXCISE TAX

Rev. Rul. 2007–20, page 863.
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ADMINISTRATIVE

Rev. Rul. 2007–19, page 843.

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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 61.—Gross Income Defined

26 CFR 1.61–2: Compensation for services, including fees, commissions, and similar items.

Frivolous tax returns; wages not taxable income. This ruling discusses and refutes the frivolous position taken by some taxpayers that wages are not taxable income.

Rev. Rul. 2007–19

PURPOSE

The Internal Revenue Service (Service) is aware that some taxpayers are attempting to reduce or eliminate their federal income tax liability by claiming that compensation received in exchange for personal services is not taxable income. These taxpayers often attempt to avoid their federal income tax liability by failing to file federal income tax returns or by failing to report all income from wages or other compensation on their federal income tax return. They often furnish Forms W–4, *Employee's Withholding Allowance Certificate*, on which they claim excessive withholding allowances or claim complete exemption from withholding. In addition, they often claim deductions from gross income for personal, living and family expenditures in order to reduce the tax liability related to wages or other compensation.

The Service is aware that some promoters and return preparers are advising or recommending that taxpayers take these or other meritless positions. This revenue ruling emphasizes to taxpayers, promoters and return preparers that wages and other compensation received in exchange for personal services are taxable income subject to federal income tax. Any argument that such compensation is not taxable income has no merit and is frivolous.

The Service is committed to identifying taxpayers who attempt to avoid their federal tax obligations by taking frivolous positions. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through the Service's Frivolous Return Program. As part of this program, the Service determines whether taxpayers who have taken frivolous positions have filed all required tax returns; computes the correct amount of tax and interest due; and determines whether civil or criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters and others who assist taxpayers in taking frivolous positions and recommends whether an injunction should be sought to halt these activities. Other information about frivolous tax positions is available on the Service website at *www.irs.gov*.

ISSUE

Whether Taxpayer A may avoid federal income tax liability by maintaining that the Internal Revenue Code does not tax wages or other compensation received in exchange for personal services.

FACTS

Taxpayer A receives wages in exchange for personal services. Taxpayer A then does one or more of the following: (1) furnishes a Form W–4 to the employer on which Taxpayer A claims excessive withholding allowances or claims complete exemption from withholding; (2) fails to file a federal income tax return; (3) fails to report the wages on the federal income tax return; (4) claims a refund for any withheld income tax; or (5) claims deductions for personal, living and family expenditures to offset the wages reported on the federal income tax return. Taxpayer A claims that compensation received for personal services is not subject to federal income tax.

Arguments that wages are not subject to federal income tax take many forms including, but not limited to, the following:

1. A tax on wages is a direct tax subject to the provision in Article I, Section 2, Clause 3 of the Constitution that requires that direct taxes be apportioned among the states by population.

2. Money received in exchange for personal labor constitutes an equal, nontaxable exchange of property.

3. Taxable income from wages or other compensation for personal services can only be determined after deduction of the cost of providing the labor.

LAW AND ANALYSIS

1. Article 1, Section 2, Clause 3 of the United States Constitution states that "direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers . . . ." This statement has been used to support the argument that there is a constitutional impediment to the imposition of a direct tax on an individual's wages. The Sixteenth Amendment to the Constitution, ratified in 1913, provides that "[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." The Sixteenth Amendment has been reviewed by the Supreme Court and upheld. *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916). Thus, the imposition of income tax on wages, without apportionment among the states, is authorized. *See, e.g., Funk v. Commissioner*, 687 F.2d 264 (8th Cir. 1982); *Abrams v. Commissioner*, 82 T.C. 403 (1984).

Section 61(a) of the Internal Revenue Code defines gross income as income from whatever source derived, including (but not limited to) "compensation for services, including fees, commissions, fringe benefits, and similar items." I.R.C. § 61(a)(1). Courts consistently have upheld the determination that wages fall within section 61(a)(1)'s definition of compensation and, accordingly, constitute taxable income. *See*, *e.g.*, *Ledford v. United States*, 297 F.3d 1378 (Fed. Cir. 2002); *United States v. Connor*, 898 F.2d 942 (3d Cir. 1990); *Casper v. Commissioner*, 805 F.2d 902 (10th Cir. 1986); *Connor v. Commissioner*, 770 F.2d 17 (2d Cir. 1985); *Lovell v. United States*, 755 F.2d 517 (7th Cir. 1984); *Perkins v. Commissioner*, 746 F.2d 1187 (6th Cir. 1984); *Funk v. Commis-*

sioner, 687 F.2d 264 (8th Cir. 1982); *Lonsdale v. Commissioner*, 661 F.2d 71 (5th Cir. 1981); *Rowlee v. Commissioner*, 80 T.C. 1111 (1983).

In *United States v. Connor*, 898 F.2d at 943, the Third Circuit noted that "[e]very court which has ever considered the issue has unequivocally rejected the argument that wages are not income." All income received by a taxpayer is income under section 61 unless it is specifically exempted or excluded. *See Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429–30 (1955) ("Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to the intention of Congress to tax all gains except those specifically exempted.").

2. Some taxpayers claim that the payment of wages or other compensation in exchange for personal labor is a nontaxable exchange of property. These taxpayers sometimes rely on sections 83 or 1001 of the Internal Revenue Code to support this argument. Section 83 provides for the determination of the amount to be included in gross income and the timing of the inclusion when property is transferred to an employee or independent contractor in connection with the performance of services. Section 1001 provides for the determination of the amount and timing of the recognition of gain or loss from the sale or other disposition of property.

Courts have universally rejected the argument that labor is property that can be exchanged for wages or other compensation in a nontaxable transaction. *See Casper v. Commissioner*, 805 F.2d at 905; *Funk v. Commissioner*, 687 F.2d at 265. Courts recognize a distinction between selling labor and selling or exchanging property. *See Reading v. Commissioner*, 70 T.C. 730, 733–34 (1978), *aff'd*, 614 F.2d 159 (8th Cir. 1980). Further, the courts have concluded that a taxpayer has no tax basis in one's labor and, therefore, the full amount of the wages or other compensation received represents gain which may be taxed as income. *See*, *e.g.*, *Casper*, 805 F.2d at 905; *Abrams*, 82 T.C. at 407; *Reading*, 70 T.C. at 733–34.

3. A related argument is that income from the sale of labor cannot be determined until the taxpayer's investment in that labor has been recovered. This argument has been repeatedly rejected. *See Rowlee*, 80 T.C. at 1120; *Reading*, 70 T.C. at 733–34. In *Reading*, the Tax Court examined the contention that gain must be realized for there to be income, analyzing the distinction recognized under federal tax law between producing a physical product and providing services. The court flatly rejected the idea that living expenses constitute the cost of "goods" sold for providing labor or services. *Reading*, 70 T.C. at 733–34. Thus, the court concluded that the gain from the sale of labor is the entire amount received and upheld the disallowance of deductions for personal living expenses.

Courts have uniformly rejected arguments that wages and other compensation for personal services are not taxable income. Accordingly, raising these arguments justifies the imposition of sanctions. *See Ledford v. United States*, 297 F.3d at 1381–82 (Fed. Cir. 2002); *Casper v. Commissioner*, 805 F.2d at 906; *Connor v. Commissioner*, 770 F.2d at 20.

HOLDING

1. Wages fall within the definition of income set forth in section 61(a)(1) of the Internal Revenue Code. Taxpayer A's wages and other compensation for services are income subject to federal income tax and must be reported on Taxpayer A's federal income tax return.

2. The payment of wages and other compensation for personal services is not an equal exchange of property. The full amount of wages received by Taxpayer A is subject to federal income tax and must be reported on Taxpayer A's federal income tax return.

3. Wages and other compensation received by Taxpayer A in exchange for personal services are subject to federal income tax without reduction of Taxpayer A's personal living expenses.

CIVIL AND CRIMINAL PENALTIES

The Service will challenge the claims of individuals who improperly attempt to avoid or evade their federal tax liability. In addition to liability for the tax due plus statutory interest, taxpayers who fail to file valid returns or pay tax based on arguments that wages and other compensation for personal services are exempt from federal income tax face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalties, which are generally equal to 20 percent of the amount of tax the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of tax the taxpayer should have paid; (3) the section 6702(a) penalty of $5,000 for a "frivolous tax return"; (4) the section 6702(b) penalty of $5,000 for submitting a "specified frivolous submission"; (5) the section 6651 additions to tax for failure to file a return, failure to pay the tax owed, and fraudulent failure to file a return; (6) the section 6673 penalty of up to $25,000 if the taxpayer makes frivolous arguments in the United States Tax Court; and (7) the section 6682 penalty of $500 for providing false information with respect to withholding.

Taxpayers relying on these frivolous positions also may face criminal prosecution under: (1) section 7201 for attempting to evade or defeat tax, the penalty for which is a significant fine and imprisonment for up to 5 years; (2) section 7203 for willful failure to file a return, the penalty for which is a significant fine and imprisonment for up to one year; (3) section 7206 for making false statements on a return, statement, or other document, the penalty for which is a significant fine and imprisonment for up to 3 years; or (4) other provisions of federal law.

Persons, including return preparers, who promote these frivolous positions and those who assist taxpayers in claiming tax benefits based on frivolous positions may face civil and criminal penalties and also may be enjoined by a court pursuant to sections 7407 and 7408. Potential penalties include: (1) a $250 penalty under section 6694 for each return or claim for refund prepared by an income tax return preparer who knew or should have known that the taxpayer's position was frivolous (or $1,000 for each return or claim for refund if the return preparer's actions were willful, intentional or reckless); (2) a penalty under section 6700 for promoting abusive tax shelters; (3) a $1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (4) criminal prosecution under section 7206, for which

the penalty is a significant fine and imprisonment for up to 3 years, for assisting or advising about the preparation of a false return, statement or other document under the internal revenue laws.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office at (202) 622–7950 (not a toll-free call).

Section 168.—Accelerated Cost Recovery System

26 CFR 1.168(a)–1: Modified accelerated cost recovery system.

T.D. 9314

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Depreciation of MACRS Property That is Acquired in a Like-Kind Exchange or As a Result of an Involuntary Conversion

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the depreciation of property subject to the accelerated cost recovery system under section 168 of the Internal Revenue Code (MACRS property). Specifically, these final regulations provide guidance on how to depreciate MACRS property acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033 when both the acquired and relinquished property are subject to MACRS in the hands of the acquiring taxpayer. These final regulations will affect taxpayers involved in a like-kind exchange under section 1031 or an involuntary conversion under section 1033. The corresponding temporary regulations are removed.

DATES: *Effective Dates:* These regulations are effective on February 26, 2007.

Applicability Dates: For dates of applicability, see §§1.168(a)–1(b), 1.168(b)–1(b), 1.168(d)–1(d)(3), 1.168(i)–1(l), 1.168(i)–6(k), and 1.168(k)–1(g)(3)(ii).

FOR FURTHER INFORMATION CONTACT: Patrick S. Kirwan, (202) 622–3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 168 of the Internal Revenue Code (Code). Section 168 provides the depreciation deduction for tangible property generally placed in service after December 31, 1986.

On March 1, 2004, the IRS and the Treasury Department published in the **Federal Register** (69 FR 9529) temporary regulations (T.D. 9115, 2004–1 C.B. 680) relating to the depreciation allowable for tangible property of a character subject to the allowance for depreciation provided in section 167(a) that is generally placed in service after December 31, 1986, and is subject to section 168 (MACRS property) that is acquired in a like-kind exchange or as a result of involuntary conversion. On the same date the IRS published a notice of proposed rulemaking related to this topic in the **Federal Register** (REG–106590–00, REG–138499–02, 2004–1 C.B. 704 [69 FR 9560]). No public hearing on the regulations was requested or held. Several written comments to the notice of proposed rulemaking were received. After consideration of all the comments received, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The revisions to the proposed regulations are discussed in this preamble. Unless otherwise specifically stated, references to the temporary regulations are to T.D. 9115.

General Overview

Section 167 allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in a trade or business or held for the production of income. The depreciation allowable for depreciable tangible property placed in service after 1986 generally is determined under section 168. Section 1001 generally provides for the recognition of gain or loss on the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized on an exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment. Section 1031(b) provides that if an exchange would be within the provision of section 1031(a) were it not for the fact that the property received in the exchange consists not only of property permitted to be received in such an exchange, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. Under section 1031(c), no loss from a transaction that also involves other property or money is recognized. Under section 1031(d), the basis of property acquired in an exchange described in section 1031 is the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by the amount of gain (or decreased by the amount of loss) that was recognized on such exchange.

Section 1033(a)(1) provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain is recognized. Under section 1033(b)(1), the basis of property acquired by the taxpayer in such a transaction is the basis of the converted property. Under section 1033(a)(2)(A), if property is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, and, within the time frame described in section 1033(a)(2)(B),

the taxpayer purchases other property that is related in service or use to the converted property or purchases stock in the acquisition of control of a corporation owning such property, then the taxpayer may elect to recognize gain only to the extent that the amount realized upon such conversion exceeds the cost of such other property or stock. Under section 1033(b)(2), if such an election is made, the basis of the replacement property acquired by the taxpayer generally is the cost of that property decreased by any gain not recognized by reason of section 1033(a)(2).

Summary of Comments and Explanation of Provisions

Scope

In general, the final regulations adopt the rules outlined in the proposed and temporary regulations with the addition of some clarifying language and examples provided in response to comments. The temporary regulations provided guidance as to how to determine the annual depreciation allowance under section 168 for replacement property acquired in a like-kind exchange or involuntary conversion. However, the temporary regulations did not apply to a like-kind exchange or involuntary conversion if the allowance for depreciation of either the relinquished or replacement property is computed under a depreciation system other than section 168 (MACRS), or for which a taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS. A commentator requested that the final regulations apply to all property acquired in a like-kind exchange or involuntary conversion. However, it is anticipated that the vast majority of like-kind exchanges and involuntary conversions occurring after the effective date of the final regulations will involve the exchange of MACRS property. In addition, there are differences between MACRS and other depreciation systems which would require the creation of additional rules which would only apply in a limited number of circumstances. Furthermore, certain types of property are statutorily excluded from being treated as MACRS property. Therefore, the final regulations do not adopt the commentator's suggestion. However, the final regulations allow a taxpayer to elect to treat the sum of the exchanged basis and excess basis of the replacement property as MACRS property that is placed in service at the time of replacement if the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS. For example, a taxpayer that exchanges a machine depreciated under the unit of production method for a used machine may depreciate under MACRS the sum of the exchanged basis and excess basis of the used machine (replacement property) as a machine placed in service at the time of replacement.

Optional Depreciation Tables

For taxpayers who wish to use the optional depreciation tables to determine the depreciation allowances for the replacement MACRS property instead of the formulas (for example, see section 6 of Rev. Proc. 87–57, 1987–2 C.B. 687, 692), the final regulations provide guidance on choosing the applicable optional table as well as how to modify the calculation for computing the depreciation allowances for the replacement MACRS property. A commentator noted that under the temporary regulations depreciation computed using the optional tables could be different than the depreciation computed using the formulas and suggested adopting a different transaction coefficient. The IRS and Treasury recognize that use of the optional depreciation tables may result in a different computation of depreciation. Nonetheless, the optional depreciation tables are intended to provide an alternative method of calculating depreciation for taxpayers. Furthermore, the transaction coefficient formula provided in the temporary regulations is consistent with transaction coefficient formulas provided in other depreciation guidance. Therefore, the final regulations retain the rules provided in the temporary regulations.

Depreciation Convention Provisions

Several comments were received about the application of the depreciation convention provisions under the temporary regulations. In response to these comments, several changes were made in the final regulations. Section 1.168(i)–6(c)(5)(ii)(A) was added in order to provide an explanation of the applicable convention separate from the explanation of the rule for determining the remaining recovery period for the replacement MACRS property. Section 1.168(i)–6(c)(4)(v) specifically addresses the convention that applies to the exchanged basis when the year of replacement is after the year of disposition and the relinquished MACRS property was placed in service in the year of disposition. Section 1.168(i)–6(c)(5)(i)(B) of the final regulations contains a new rule that provides that if, using the convention that applies to the relinquished MACRS property, the remaining recovery period of the relinquished MACRS property at the beginning of the year of disposition is less than the number of months between the first of that year and the time of disposition, the entire basis in the relinquished MACRS property is deductible in the year of disposition and the exchanged basis is zero. In light of this new rule, *Example 4* of §1.168(i)–6T(c)(6) of the temporary regulations has been replaced by *Example 5* of §1.168(i)–6(c)(6).

Deferred Exchanges

The temporary regulations did not permit a taxpayer to take depreciation on relinquished MACRS property during the period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property. A comment was received which noted that under the half-year convention if relinquished MACRS property is disposed of in year 1 and the replacement MACRS property is not acquired until year 2, the taxpayer would only be entitled to deduct a half-year of depreciation in each year. The IRS and Treasury Department recognize that this result could occur under the convention rules. However, similar results occur when property is disposed of and replaced in a transaction to which section 1031 or section 1033 do not apply. In addition, the IRS and Treasury Department believe that a taxpayer cannot depreciate property the taxpayer does not own. Therefore, the final regulations retain the rule provided in the temporary regulations with respect to this issue. The final regulations reserve on providing spe-

cific guidance as to whether an intermediary (such as an exchange accommodation titleholder) is entitled to depreciation.

Acquisition Prior to Disposition for an Involuntary Conversion

The temporary regulations allowed taxpayers to begin depreciating replacement property upon acquisition even if the acquisition occurs prior the disposition of the relinquished property if the replacement property is acquired to meet the requirements of section 1033(a)(2)(B) (acquisition under threat of condemnation). However, the temporary regulations also required taxpayers to include in taxable income any excess depreciation allowable on the unadjusted depreciable basis of the replacement MACRS property over the depreciation allowable on the excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer to the time of disposition of the relinquished MACRS property. A comment was received suggesting that taxpayers be permitted to reduce the exchanged basis of the replacement property by the excess depreciation rather than requiring a taxpayer to recognize the excess depreciation as taxable income. This suggestion was not adopted in the final regulations because it would have the effect of inappropriately accelerating depreciation deductions for the replacement property.

Exchanges of Multiple Properties

The determination of the basis of property acquired in a like-kind exchange involving multiple properties is described in §1.1031(j)–1 and the determination of the basis of multiple properties acquired as a result of an involuntary conversion is described in §1.1033(b)–1. Commentators requested examples to show how the temporary regulations apply to the depreciation treatment of a like-kind exchange or an involuntary conversion involving multiple properties. Other commentators suggested that taxpayers be permitted to use any reasonable, consistent method of allocating basis among the properties. The IRS and Treasury Department believe that these comments concern the allocation of basis principles under sections 1031 and 1033, rather than the depreciation rules under section 168. Once basis in property is determined or allocated under section 1031 or section 1033, these final regulations would then apply for determining the depreciation allowable with respect to such basis. The IRS and Treasury Department believe that issues related to allocation of basis among multiple properties involved in like-kind exchanges or involuntary conversions for purposes of depreciation are beyond the scope of the final regulations. Therefore the final regulations do not address these issues. However, the IRS and Treasury Department intend to invite interested parties to submit written comments regarding whether additional published guidance is needed in this area, and to invite written comments that specifically propose or address possible resolutions to these issues.

Transactions Involving Nondepreciable Property

A commentator requested guidance as to how depreciation is calculated if the relinquished property was only partially used for business purposes. In response to this comment, the final regulations provide an example to show how depreciation is calculated on replacement property received in exchange for property that was used only partially for business purposes (see *Example 2* in §1.168(i)–6(d)(3)(iii)).

General Asset Accounts

Under the temporary regulations, general asset account treatment terminates for the relinquished MACRS property as of the first day of the year of disposition. Because this rule would require taxpayers to track each property in a general asset account, the IRS and Treasury Department requested comments on alternative methods to account for a like-kind exchange or involuntary conversion involving MACRS property contained in a general asset account when the replacement MACRS property has a longer recovery period or less accelerated depreciation method than the relinquished MACRS property or when the basis of the general asset account would change as a result of the like-kind exchange or involuntary conversion. No comments were received on this rule and no alternatives were suggested. Therefore, the regulations are adopted as proposed.

Effective Date

These final regulations generally apply to a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004. For a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may apply these final regulations or rely on prior guidance issued by the IRS.

Special Analyses

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

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Sections 1.168(a)–1 and 1.168(b)–1 are added to read as follows:

§1.168(a)–1 Modified accelerated cost recovery system.

(a) Section 168 determines the depreciation allowance for tangible property that is of a character subject to the allowance for depreciation provided in section 167(a) and that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143). Except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule, the provisions of section 168 are mandatory for all eligible property. The allowance for depreciation under section 168 constitutes the amount of depreciation allowable under section 167(a). The determination of whether tangible property is property of a character subject to the allowance for depreciation is made under section 167 and the regulations under section 167.

(b) This section is applicable on and after February 27, 2004.

§1.168(b)–1 Definitions.

(a) *Definitions*. For purposes of section 168 and the regulations under section 168, the following definitions apply:

(1) *Depreciable property* is property that is of a character subject to the allowance for depreciation as determined under section 167 and the regulations under section 167.

(2) *MACRS property* is tangible, depreciable property that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143) and subject to section 168, except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule.

(3) *Unadjusted depreciable basis* is the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179, section 179C, or any similar provision, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations under the Code (other than section 1016(a)(2) and (3)) (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

(4) *Adjusted depreciable basis* is the unadjusted depreciable basis of the property, as defined in §1.168(b)–1(a)(3), less the adjustments described in section 1016(a)(2) and (3).

(b) *Effective date*. This section is applicable on or after February 27, 2004.

§§1.168(a)–1T and 1.168(b)–1T [Removed]

Par. 3. Sections 1.168(a)–1T and 1.168(b)–1T are removed.

Par. 4. Section 1.168(d)–1 is amended by revising the section heading and paragraphs (b)(3) and (d)(3) to read as follows:

§1.168(d)–1 Applicable conventions—half-year and mid-quarter conventions.

* * * * *

(b) * * *

(3) *Property placed in service and disposed of in the same taxable year*. (i) Under section 168(d)(3)(B)(ii), the depreciable basis of property placed in service and disposed of in the same taxable year is not taken into account in determining whether the 40-percent test is satisfied. However, the depreciable basis of property placed in service, disposed of, subsequently reacquired, and again placed in service, by the taxpayer in the same taxable year must be taken into account in applying the 40-percent test, but the basis of the property is only taken into account on the later of the dates that the property is placed in service by the taxpayer during the taxable year. Further, see §§1.168(i)–6(c)(4)(v)(B) and 1.168(i)–6(f) for rules relating to property placed in service and exchanged or involuntarily converted during the same taxable year.

(ii) The applicable convention, as determined under this section, applies to all depreciable property (except nonresidential real property, residential rental property, and any railroad grading or tunnel bore) placed in service by the taxpayer during the taxable year, excluding property placed in service and disposed of in the same taxable year. However, see §§1.168(i)–6(c)(4)(v)(A) and 1.168(i)–6(f) for rules relating to MACRS property that has a basis determined under section 1031(d) or section 1033(b). No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year. However, see §1.168(k)–1(f)(1) for rules relating to qualified property or 50-percent bonus depreciation property, and §1.1400L(b)–1(f)(1) for rules relating to qualified New York Liberty Zone property, that is placed in service by the taxpayer in the same taxable year in which either a partnership is terminated as a result of a technical termination under section 708(b)(1)(B) or the property is transferred in a transaction described in section 168(i)(7).

* * * * *

(d) * * *

(3) *Like-kind exchanges and involuntary conversions*. The last sentence in paragraph (b)(3)(i) and the second sentence in paragraph (b)(3)(ii) of this section apply to exchanges to which section 1031 applies, and involuntary conversions to which section 1033 applies, of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004.

§1.168(d)–1T [Removed]

Par. 5. Section 1.168(d)–1T is removed.

Par. 6. Section 1.168(i)–0 is amended as follows:

1. The entries for §1.168(i)–1(d)(2), (e)(3)(i), (e)(3)(v), (e)(3)(vi), (f), (f)(1), (f)(2), (f)(2)(i), (i), (j), and (l) are revised.

2. The entries for §1.168(i)–1(l)(1), (l)(2), and (l)(3) are added.

The revisions and additions read as follows:

§1.168(i)–0 Table of contents for the general asset account rules.

* * * * *

§1.168(i)–1 General asset accounts.

* * * * *

(d) * * *

(2) Special rule for passenger automobiles.

* * * * *

(e) * * *

(3) * * *

(i) In general.

* * * * *

(v) Transactions subject to section 1031 or 1033.

(vi) Anti-abuse rule.

* * * * *

(f) Assets generating foreign source income.

(1) In general.

(2) Source of ordinary income, gain, or loss.

(i) Source determined by allocation and apportionment of depreciation allowed.

* * * * *

(i) Identification of disposed or converted asset.

(j) Effect of adjustments on prior dispositions.

* * * * *

(l) Effective date.

(1) In general.

(2) Exceptions.

(3) Like-kind exchanges and involuntary conversions.

§1.168(i)–0T [Removed]

Par. 7. Section 1.168(i)–0T is removed.

Par. 8. Section 1.168(i)–1 is amended as follows:

1. Paragraphs (d)(2), (e)(3)(i), (e)(3)(iii)(B)(*4*), (e)(3)(v), (e)(3)(vi), (f)(1), (f)(2)(i), (i), (j), (l)(1), and (l)(3) are revised.

2. The first sentence in paragraph (l)(2)(ii)(B) is amended by removing the language "as modified by Rev. Proc. 2004–11, 2004–1 C.B. 311".

The revisions read as follows:

§1.168(i)–1 General asset accounts.

* * * * *

(d) * * *

(2) *Special rule for passenger automobiles*. For purposes of applying section 280F(a), the depreciation allowance for a general asset account established for passenger automobiles is limited for each taxable year to the amount prescribed in section 280F(a) multiplied by the excess of the number of automobiles originally included in the account over the number of automobiles disposed of during the taxable year or in any prior taxable year in a transaction described in paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(iv) (transactions subject to section 168(i)(7)), (e)(3)(v) (transactions subject to section 1031 or 1033), (e)(3)(vi) (anti-abuse rule), (g) (assets subject to recapture), or (h)(1) (conversion to personal use) of this section.

(e) * * *

(3) * * *

(i) *In general*. This paragraph (e)(3) provides the rules for terminating general asset account treatment upon certain dispositions. While the rules under paragraphs (e)(3)(ii) and (iii) of this section are optional rules, the rules under paragraphs (e)(3)(iv), (v), and (vi) of this section are mandatory rules. A taxpayer applies paragraph (e)(3)(ii) or (iii) of this section by reporting the gain, loss, or other deduction on the taxpayer's timely filed Federal income tax return (including extensions) for the taxable year in which the disposition occurs. For purposes of applying paragraph (e)(3)(iii) through (vi) of this section, see paragraph (i) of this section for identifying the unadjusted depreciable basis of a disposed asset.

* * * * *

(iii) * * *

(B) * * *

(*4*) A transaction, other than a transaction described in paragraphs (e)(3)(iv) (pertaining to transactions subject to section 168(i)(7)) and (e)(3)(v) (pertaining to transactions subject to section 1031 or 1033) of this section, to which a nonrecognition section of the Code applies (determined without regard to this section).

* * * * *

(v) *Transactions subject to section 1031 or section 1033*—(A) *Like-kind exchange or involuntary conversion of all assets remaining in a general asset account*. If all the assets, or the last asset, in a general asset account are transferred by a taxpayer in a like-kind exchange (as defined under §1.168–6(b)(11)) or in an involuntary conversion (as defined under §1.168–6(b)(12)), the taxpayer must apply this paragraph (e)(3)(v)(A) (instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section). Under this paragraph (e)(3)(v)(A), the general asset account terminates as of the first day of the year of disposition (as defined in §1.168(i)–6(b)(5)) and—

(*1*) The amount of gain or loss for the general asset account is determined under section 1001(a) by taking into account the adjusted depreciable basis of the general asset account at the time of disposition (as defined in §1.168(i)–6(b)(3)). The depreciation allowance for the general asset account in the year of disposition is determined in the same manner as the depreciation allowance for the relinquished MACRS property (as defined in §1.168(i)–6(b)(2)) in the year of disposition is determined under §1.168(i)–6. The recognition and character of gain or loss are determined in accordance with paragraph (e)(3)(ii)(A) of this section (notwithstanding that paragraph (e)(3)(ii) of this section is an optional rule); and

(*2*) The adjusted depreciable basis of the general asset account at the time of disposition is treated as the adjusted depreciable basis of the relinquished MACRS property.

(B) *Like-kind exchange or involuntary conversion of less than all assets remaining in a general asset account*. If an asset in a general asset account is transferred by a taxpayer in a like-kind exchange or in an involuntary conversion and if paragraph (e)(3)(v)(A) of this section does not apply to this asset, the taxpayer must apply this paragraph (e)(3)(v)(B) (instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section). Under this paragraph (e)(3)(v)(B), general asset account treatment for the asset terminates as of the first day of the year of disposition (as defined in §1.168(i)–6(b)(5)), and—

(*1*) The amount of gain or loss for the asset is determined by taking into account the asset's adjusted basis at the time of disposition (as defined in §1.168(i)–6(b)(3)). The adjusted basis of the asset at the time of disposition equals the unadjusted depreciable basis of the asset less the depreciation allowed or allowable for the asset, computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included. The depreciation allowance for the asset in the year of disposition is determined in the same manner as the depreciation allowance for the

relinquished MACRS property (as defined in §1.168(i)–6(b)(2)) in the year of disposition is determined under §1.168(i)–6. The recognition and character of the gain or loss are determined in accordance with paragraph (e)(3)(iii)(A) of this section (notwithstanding that paragraph (e)(3)(iii) of this section is an optional rule); and

(*2*) As of the first day of the year of disposition, the taxpayer must remove the relinquished asset from the general asset account and make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(vi) *Anti-abuse rule*—(A) *In general*. If an asset in a general asset account is disposed of by a taxpayer in a transaction described in paragraph (e)(3)(vi)(B) of this section, general asset account treatment for the asset terminates as of the first day of the taxable year in which the disposition occurs. Consequently, the taxpayer must determine the amount of gain, loss, or other deduction attributable to the disposition in the manner described in paragraph (e)(3)(iii)(A) of this section (notwithstanding that paragraph (e)(3)(iii)(A) of this section is an optional rule) and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*1*) through (*4*) of this section.

(B) *Abusive transactions*. A transaction is described in this paragraph (e)(3)(vi)(B) if the transaction is not described in paragraph (e)(3)(iv) or (e)(3)(v) of this section and the transaction is entered into, or made, with a principal purpose of achieving a tax benefit or result that would not be available absent an election under this section. Examples of these types of transactions include—

(*1*) A transaction entered into with a principal purpose of shifting income or deductions among taxpayers in a manner that would not be possible absent an election under this section in order to take advantage of differing effective tax rates among the taxpayers; or

(*2*) An election made under this section with a principal purpose of disposing of an asset from a general asset account in order to utilize an expiring net operating loss or credit. The fact that a taxpayer with a net operating loss carryover or a credit carryover transfers an asset to a related person or transfers an asset pursuant to an arrangement where the asset continues to be used (or is available for use) by the taxpayer pursuant to a lease (or otherwise) indicates, absent strong evidence to the contrary, that the transaction is described in this paragraph (e)(3)(vi)(B).

(f) * * *

(1) *In general*. This paragraph (f) provides the rules for determining the source of any income, gain, or loss recognized, and the appropriate section 904(d) separate limitation category or categories for any foreign source income, gain, or loss recognized, on a disposition (within the meaning of paragraph (e)(1) of this section) of an asset in a general asset account that consists of assets generating both United States and foreign source income. These rules apply only to a disposition to which paragraph (e)(2) (general disposition rules), (e)(3)(ii) (disposition of all assets remaining in a general asset account), (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(v) (transactions subject to section 1031 or 1033), or (e)(3)(vi) (anti-abuse rule) of this section applies.

(2) * * *

(i) *Source determined by allocation and apportionment of depreciation allowed*. The amount of any ordinary income, gain, or loss that is recognized on the disposition of an asset in a general asset account must be apportioned between United States and foreign sources based on the allocation and apportionment of the—

(A) Depreciation allowed for the general asset account as of the end of the taxable year in which the disposition occurs if paragraph (e)(2) of this section applies to the disposition;

(B) Depreciation allowed for the general asset account as of the time of disposition if the taxpayer applies paragraph (e)(3)(ii) of this section to the disposition of all assets, or the last asset, in the general asset account, or if all the assets, or the last asset, in the general asset account are disposed of in a transaction described in paragraph (e)(3)(v)(A) of this section; or

(C) Depreciation allowed for the disposed asset for only the taxable year in which the disposition occurs if the taxpayer applies paragraph (e)(3)(iii) of this section to the disposition of the asset in a qualifying disposition, if the asset is disposed of in a transaction described in paragraph (e)(3)(v)(B) of this section (like-kind exchange or involuntary conversion), or if the asset is disposed in a transaction described in paragraph (e)(3)(vi) of this section (anti-abuse rule).

* * * * *

(i) * * * A taxpayer may use any reasonable method that is consistently applied to the taxpayer's general asset accounts for purposes of determining the unadjusted depreciable basis of a disposed or converted asset in a transaction described in paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(iv) (transactions subject to section 168(i)(7)), (e)(3)(v) (transactions subject to section 1031 or 1033), (e)(3)(vi) (anti-abuse rule), (g) (assets subject to recapture), or (h)(1) (conversion to personal use) of this section.

(j) *Effect of adjustments on prior dispositions*. The adjustments to a general asset account under paragraph (e)(3)(iii), (e)(3)(iv), (e)(3)(v), (e)(3)(vi), (g), or (h)(1) of this section have no effect on the recognition and character of prior dispositions subject to paragraph (e)(2) of this section.

* * * * *

(l) * * *

(1) *In general*. Except as provided in paragraphs (l)(2) and (l)(3) of this section, this section applies to depreciable assets placed in service in taxable years ending on or after October 11, 1994. For depreciable assets placed in service after December 31, 1986, in taxable years ending before October 11, 1994, the Internal Revenue Service will allow any reasonable method that is consistently applied to the taxpayer's general asset accounts.

* * * * *

(3) *Like-kind exchanges and involuntary conversions*. This section applies for an asset transferred by a taxpayer in a like-kind exchange (as defined under §1.168–6(b)(11)) or in an involuntary conversion (as defined under §1.168–6(b)(12)) for which the time of disposition (as defined in §1.168(i)–6(b)(3)) and the time of replacement (as defined in §1.168(i)–6(b)(4)) both occur after February 27, 2004. For an asset transferred by a taxpayer in a like-kind exchange or in an involuntary conversion for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, see §1.168(i)–1 in effect prior to February 27, 2004 (§1.168(i)–1 as contained in

26 CFR part 1 edition revised as of April 1, 2003).

§1.168(i)–1T [Removed]

Par. 9. Section 1.168(i)–1T is removed.

Par. 10. Section 1.168(i)–5 is added to read as follows:

§1.168(i)–5 Table of contents.

This section lists the major paragraphs contained in §1.168(i)–6.

§1.168(i)–6 Like-kind exchanges and involuntary conversions.

(a) Scope.
(b) Definitions.
(1) Replacement MACRS property.
(2) Relinquished MACRS property.
(3) Time of disposition.
(4) Time of replacement.
(5) Year of disposition.
(6) Year of replacement.
(7) Exchanged basis.
(8) Excess basis.
(9) Depreciable exchanged basis.
(10) Depreciable excess basis.
(11) Like-kind exchange.
(12) Involuntary conversion.
(c) Determination of depreciation allowance.
(1) Computation of the depreciation allowance for depreciable exchanged basis beginning in the year of replacement.
(i) In general.
(ii) Applicable recovery period, depreciation method, and convention.
(2) Effect of depreciation treatment of the replacement MACRS property by previous owners of the acquired property.
(3) Recovery period and/or depreciation method of the properties are the same, or both are not the same.
(i) In general.
(ii) Both the recovery period and the depreciation method are the same.
(iii) Either the recovery period or the depreciation method is the same, or both are not the same.
(4) Recovery period or depreciation method of the properties is not the same.
(i) Longer recovery period.
(ii) Shorter recovery period.
(iii) Less accelerated depreciation method.
(iv) More accelerated depreciation method.
(v) Convention.
(A) Either the relinquished MACRS property or the replacement MACRS property is mid-month property.
(B) Neither the relinquished MACRS property nor the replacement MACRS property is mid-month property.
(5) Year of disposition and year of replacement.
(i) Relinquished MACRS property.
(A) General rule.
(B) Special rule.
(ii) Replacement MACRS property.
(A) Remaining recovery period of the replacement MACRS property.
(B) Year of replacement is 12 months.
(iii) Year of disposition or year of replacement is less than 12 months.
(iv) Deferred transactions.
(A) In general.
(B) Allowable depreciation for a qualified intermediary.
(v) Remaining recovery period.
(6) Examples.
(d) Special rules for determining depreciation allowances.
(1) Excess basis.
(i) In general.
(ii) Example.
(2) Depreciable and nondepreciable property.
(3) Depreciation limitations for automobiles.
(i) In general.
(ii) Order in which limitations on depreciation under section 280F(a) are applied.
(iii) Examples.
(4) Involuntary conversion for which the replacement MACRS property is acquired and placed in service before disposition of relinquished MACRS property.
(e) Use of optional depreciation tables.
(1) Taxpayer not bound by prior use of table.
(2) Determination of the depreciation deduction.
(i) Relinquished MACRS property.
(ii) Replacement MACRS property.
(A) Determination of the appropriate optional depreciation table.
(B) Calculating the depreciation deduction for the replacement MACRS property.
(iii) Unrecovered basis.
(3) Excess basis.
(4) Examples.
(f) Mid-quarter convention.
(1) Exchanged basis.
(2) Excess basis.
(3) Depreciable property acquired for nondepreciable property.
(g) Section 179 election.
(h) Additional first year depreciation deduction.
(i) Elections.
(1) Election not to apply this section.
(2) Election to treat certain replacement property as MACRS property.
(j) Time and manner of making election under paragraph (i)(1) of this section.
(1) In general.
(2) Time for making election.
(3) Manner of making election.
(4) Revocation.
(k) Effective date.
(1) In general.
(2) Application to pre-effective date like-kind exchanges and involuntary conversions.
(3) Like-kind exchanges and involuntary conversions where the taxpayer made the election under section 168(f)(1) for the relinquished property.

§1.168(i)–5T [Removed]

Par. 11. Section 1.168(i)–5T is removed.

Par. 12. Section 1.168(i)–6 is added to read as follows:

§1.168(i)–6 Like-kind exchanges and involuntary conversions.

(a) *Scope*. This section provides the rules for determining the depreciation allowance for MACRS property acquired in a like-kind exchange or an involuntary conversion, including a like-kind exchange or an involuntary conversion of MACRS property that is exchanged or replaced with other MACRS property in a transaction between members of the same affiliated group. The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a) for the year of replacement and any subsequent taxable year for the replacement MACRS property and for the year of disposition of the relinquished MACRS property. The provisions of this section apply only to MACRS property to which §1.168(h)–1 (like-kind exchanges of tax-exempt use property) does not apply. Additionally, paragraphs (c) through (f) of this section apply only to MACRS property for which an election under paragraph (i) of this section has not been made.

(b) *Definitions*. For purposes of this section, the following definitions apply:

(1) *Replacement MACRS property* is MACRS property (as defined in §1.168(b)–1(a)(2)) in the hands of the acquiring taxpayer that is acquired for other MACRS property in a like-kind exchange or an involuntary conversion.

(2) *Relinquished MACRS property* is MACRS property that is transferred by the taxpayer in a like-kind exchange, or in an involuntary conversion.

(3) *Time of disposition* is when the disposition of the relinquished MACRS property takes place under the convention, as determined under §1.168(d)–1, that applies to the relinquished MACRS property.

(4) *Time of replacement* is the later of—

(i) When the replacement MACRS property is placed in service under the convention, as determined under this section, that applies to the replacement MACRS property; or

(ii) The time of disposition of the exchanged or involuntarily converted property.

(5) *Year of disposition* is the taxable year that includes the time of disposition.

(6) *Year of replacement* is the taxable year that includes the time of replacement.

(7) *Exchanged basis* is determined after the depreciation deductions for the year of disposition are determined under paragraph (c)(5)(i) of this section and is the lesser of—

(i) The basis in the replacement MACRS property, as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b); or

(ii) The adjusted depreciable basis (as defined in §1.168(b)–1(a)(4)) of the relinquished MACRS property.

(8) *Excess basis* is any excess of the basis in the replacement MACRS property, as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b), over the exchanged basis as determined under paragraph (b)(7) of this section.

(9) *Depreciable exchanged basis* is the exchanged basis as determined under paragraph (b)(7) of this section reduced by—

(i) The percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); and

(ii) Any adjustments to basis provided by other provisions of the Internal Revenue Code (Code) and the regulations under the Code (including section 1016(a)(2) and (3), for example, depreciation deductions in the year of replacement allowable under section 168(k) or 1400L(b)).

(10) *Depreciable excess basis* is the excess basis as determined under paragraph (b)(8) of this section reduced by—

(i) The percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income);

(ii) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179; and

(iii) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (including section 1016(a)(2) and (3), for example, depreciation deductions in the year of replacement allowable under section 168(k) or 1400L(b)).

(11) *Like-kind exchange* is an exchange of property in a transaction to which section 1031(a)(1), (b), or (c) applies.

(12) *Involuntary conversion* is a transaction described in section 1033(a)(1) or (2) that resulted in the nonrecognition of any part of the gain realized as the result of the conversion.

(c) *Determination of depreciation allowance*—(1) *Computation of the depreciation allowance for depreciable exchanged basis beginning in the year of replacement*—(i) *In general*. This paragraph (c) provides rules for determining the applicable recovery period, the applicable depreciation method, and the applicable convention used to determine the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement. See paragraph (c)(5) of this section for rules relating to the computation of the depreciation allowance for the year of disposition and for the year of replacement. See paragraph (d)(1) of this section for rules relating to the computation of the depreciation allowance for depreciable excess basis. See paragraph (d)(4) of this section if the replacement MACRS property is acquired before disposition of the relinquished MACRS property in a transaction to which section 1033 applies. See paragraph (e) of this section for rules relating to the computation of the depreciation allowance using the optional depreciation tables.

(ii) *Applicable recovery period, depreciation method, and convention*. The recovery period, depreciation method, and convention determined under this paragraph (c) are the only permissible methods of accounting for MACRS property within the scope of this section unless the taxpayer makes the election under paragraph (i) of this section not to apply this section.

(2) *Effect of depreciation treatment of the replacement MACRS property by previous owners of the acquired property*. If replacement MACRS property is acquired by a taxpayer in a like-kind exchange or an involuntary conversion, the depreciation treatment of the replacement MACRS property by previous owners has no effect on the determination of depreciation allowances for the replacement MACRS property in the hands of the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property for property that was depreciated under section 168 of the Internal Revenue Code of 1954 (ACRS) by the previous owner must use this section because the replacement property will become MACRS property in the hands of the acquiring taxpayer. In addition, elections made by previous owners in determining depreciation allowances for the replacement MACRS property have no effect on the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property that the taxpayer depreciates under the general depreciation system of section 168(a) for other MACRS property that the previous owner elected to depreciate under the alternative depreciation system pursuant to section 168(g)(7) does not have to continue using the alternative depreciation system for the replacement MACRS property.

(3) *Recovery period and/or depreciation method of the properties are the same, or both are not the same*—(i) *In general*. For purposes of paragraphs (c)(3) and (c)(4) of this section in determining whether the recovery period and the depreciation method prescribed under section 168 for the replacement MACRS property are the same as the recovery period and the depreciation method prescribed under

section 168 for the relinquished MACRS property, the recovery period and the depreciation method for the replacement MACRS property are considered to be the recovery period and the depreciation method that would have applied under section 168, taking into account any elections made by the acquiring taxpayer under section 168(b)(5) or 168(g)(7), had the replacement MACRS property been placed in service by the acquiring taxpayer at the same time as the relinquished MACRS property.

(ii) *Both the recovery period and the depreciation method are the same*. If both the recovery period and the depreciation method prescribed under section 168 for the replacement MACRS property are the same as the recovery period and the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the replacement MACRS property beginning in the year of replacement are determined by using the same recovery period and depreciation method that were used for the relinquished MACRS property. Thus, the replacement MACRS property is depreciated over the remaining recovery period (taking into account the applicable convention), and by using the depreciation method, of the relinquished MACRS property. Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning with the year of replacement are determined by multiplying the depreciable exchanged basis by the applicable depreciation rate for each taxable year (for further guidance, for example, see section 6 of Rev. Proc. 87–57, 1987–2 C.B. 687, 692, and §601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Either the recovery period or the depreciation method is the same, or both are not the same*. If either the recovery period or the depreciation method prescribed under section 168 for the replacement MACRS property is the same as the recovery period or the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined using the recovery period or the depreciation method that is the same as the relinquished MACRS property. See paragraph (c)(4) of this section to determine the depreciation allowances when the recovery period or the depreciation method of the replacement MACRS property is not the same as that of the relinquished MACRS property.

(4) *Recovery period or depreciation method of the properties is not the same*. If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is not the same as the recovery period prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined under this paragraph (c)(4). Similarly, if the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is not the same as the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation method used to determine the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement is determined under this paragraph (c)(4).

(i) *Longer recovery period*. If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is longer than that prescribed for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined as though the replacement MACRS property had originally been placed in service by the acquiring taxpayer in the same taxable year the relinquished MACRS property was placed in service by the acquiring taxpayer, but using the longer recovery period of the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) and the convention determined under paragraph (c)(4)(v) of this section. Thus, the depreciable exchanged basis is depreciated over the remaining recovery period (taking into account the applicable convention) of the replacement MACRS property.

(ii) *Shorter recovery period*. If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is shorter than that of the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined using the same recovery period as that of the relinquished MACRS property. Thus, the depreciable exchanged basis is depreciated over the remaining recovery period (taking into account the applicable convention) of the relinquished MACRS property.

(iii) *Less accelerated depreciation method*—(A) If the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is less accelerated than that of the relinquished MACRS property at the time of disposition, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined as though the replacement MACRS property had originally been placed in service by the acquiring taxpayer at the same time the relinquished MACRS property was placed in service by the acquiring taxpayer, but using the less accelerated depreciation method. Thus, the depreciable exchanged basis is depreciated using the less accelerated depreciation method.

(B) Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning in the year of replacement are determined by multiplying the adjusted depreciable basis by the applicable depreciation rate for each taxable year. If, for example, the depreciation method of the replacement MACRS property in the year of replacement is the 150-percent declining balance method and the depreciation method of the relinquished MACRS property in the year of replacement is the 200-percent declining balance method, and neither method had been switched to the straight line method in the year of replacement or any prior taxable year, the applicable depreciation rate for the year of replacement and subsequent taxable years is determined by using the depreciation rate of the replacement MACRS property as if the replacement MACRS property was placed in service by the acquiring taxpayer at the same time the relinquished MACRS property was placed in service by the acquiring taxpayer, until the 150-percent declining balance method has been switched to the straight line method. If, for example, the depreciation method of

the replacement MACRS property is the straight line method, the applicable depreciation rate for the year of replacement is determined by using the remaining recovery period at the beginning of the year of disposition (as determined under this paragraph (c)(4) and taking into account the applicable convention).

(iv) *More accelerated depreciation method*—(A) If the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is more accelerated than that of the relinquished MACRS property at the time of disposition, the depreciation allowances for the replacement MACRS property beginning in the year of replacement are determined using the same depreciation method as the relinquished MACRS property.

(B) Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning in the year of replacement are determined by multiplying the adjusted depreciable basis by the applicable depreciation rate for each taxable year. If, for example, the depreciation method of the relinquished MACRS property in the year of replacement is the 150-percent declining balance method and the depreciation method of the replacement MACRS property in the year of replacement is the 200-percent declining balance method, and neither method had been switched to the straight line method in the year of replacement or any prior taxable year, the applicable depreciation rate for the year of replacement and subsequent taxable years is the same depreciation rate that applied to the relinquished MACRS property in the year of replacement, until the 150-percent declining balance method has been switched to the straight line method. If, for example, the depreciation method is the straight line method, the applicable depreciation rate for the year of replacement is determined by using the remaining recovery period at the beginning of the year of disposition (as determined under this paragraph (c)(4) and taking into account the applicable convention).

(v) *Convention*. The applicable convention for the exchanged basis is determined under this paragraph (c)(4)(v).

(A) *Either the relinquished MACRS property or the replacement MACRS property is mid-month property*. If either the relinquished MACRS property or the replacement MACRS property is property for which the applicable convention (as determined under section 168(d)) is the mid-month convention, the exchanged basis must be depreciated using the mid-month convention.

(B) *Neither the relinquished MACRS property nor the replacement MACRS property is mid-month property*. If neither the relinquished MACRS property nor the replacement MACRS property is property for which the applicable convention (as determined under section 168(d)) is the mid-month convention, the applicable convention for the exchanged basis is the same convention that applied to the relinquished MACRS property. If the relinquished MACRS property is placed in service in the year of disposition, and the time of replacement is also in the year of disposition, the convention that applies to the relinquished MACRS property is determined under paragraph (f)(1)(i) of this section. If, however, relinquished MACRS property was placed in service in the year of disposition and the time of replacement is in a taxable year subsequent to the year of disposition, the convention that applies to the exchanged basis is the convention that applies in that subsequent taxable year (see paragraph (f)(1)(ii) of this section).

(5) *Year of disposition and year of replacement*. No depreciation deduction is allowable for MACRS property disposed of by a taxpayer in a like-kind exchange or involuntary conversion in the same taxable year that such property was placed in service by the taxpayer. If replacement MACRS property is disposed of by a taxpayer during the same taxable year that the relinquished MACRS property is placed in service by the taxpayer, no depreciation deduction is allowable for either MACRS property. Otherwise, the depreciation allowances for the year of disposition and for the year of replacement are determined as follows:

(i) *Relinquished MACRS property*—(A) *General rule*. Except as provided in paragraphs (c)(5)(i)(B), (c)(5)(iii), (e), and (i) of this section, the depreciation allowance in the year of disposition for the relinquished MACRS property is computed by multiplying the allowable depreciation deduction for the property for that year by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of disposition (taking into account the applicable convention of the relinquished MACRS property), and the denominator of which is 12. In the case of termination under §1.168(i)–1(e)(3)(v) of general asset account treatment of an asset, or of all the assets remaining, in a general asset account, the allowable depreciation deduction in the year of disposition for the asset or assets for which general asset account treatment is terminated is determined using the depreciation method, recovery period, and convention of the general asset account. This allowable depreciation deduction is adjusted to account for the period the asset or assets is deemed to be in service in accordance with this paragraph (c)(5)(i).

(B) *Special rule*. If, at the beginning of the year of disposition, the remaining recovery period of the relinquished MACRS property, taking into account the applicable convention of such property, is less than the period between the beginning of the year of disposition and the time of disposition, the depreciation deduction for the relinquished MACRS property for the year of disposition is equal to the adjusted depreciable basis of the relinquished MACRS property at the beginning of the year of disposition. If this paragraph applies, the exchanged basis is zero and no depreciation is allowable for the exchanged basis in the replacement MACRS property.

(ii) *Replacement MACRS property*—(A) *Remaining recovery period of the replacement MACRS property*. The replacement MACRS property is treated as placed in service at the time of replacement under the convention that applies to the replacement MACRS property as determined under this paragraph (c)(5)(ii). The remaining recovery period of the replacement MACRS property at the time of replacement is the excess of the recovery period for the replacement MACRS property, as determined under paragraph (c) of this section, over the period of time that the replacement MACRS property would have been in service if it had been placed in service when the relinquished

MACRS property was placed in service and removed from service at the time of disposition of the relinquished MACRS property. This period is determined by using the convention that applied to the relinquished MACRS property to determine the date that the relinquished MACRS property is deemed to have been placed in service and the date that it is deemed to have been disposed of. The length of time the replacement MACRS property would have been in service is determined by using these dates and the convention that applies to the replacement MACRS property.

(B) *Year of replacement is 12 months*. Except as provided in paragraphs (c)(5)(iii), (e), and (i) of this section, the depreciation allowance in the year of replacement for the depreciable exchanged basis is determined by—

(*1*) Calculating the applicable depreciation rate for the replacement MACRS property as of the beginning of the year of replacement taking into account the depreciation method prescribed for the replacement MACRS property under paragraph (c)(3) of this section and the remaining recovery period of the replacement MACRS property as of the beginning of the year of disposition as determined under this paragraph (c)(5)(ii);

(*2*) Calculating the depreciable exchanged basis of the replacement MACRS property, and adding to that amount the amount determined under paragraph (c)(5)(i) of this section for the year of disposition; and

(*3*) Multiplying the product of the amounts determined under paragraphs (c)(5)(ii)(B)(*1*) and (B)(*2*) of this section by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be in service during the year of replacement (in the year of replacement the replacement MACRS property is deemed to be placed in service by the acquiring taxpayer at the time of replacement under the convention determined under paragraph (c)(4)(v) of this section), and the denominator of which is 12.

(iii) *Year of disposition or year of replacement is less than 12 months*. If the year of disposition or the year of replacement is less than 12 months, the depreciation allowance determined under paragraph (c)(5)(ii)(A) of this section must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15, 1989–1 C.B. 816, and §601.601(d)(2)(ii)(*b*) of this chapter).

(iv) *Deferred transactions*—(A) *In general*. If the replacement MACRS property is not acquired until after the disposition of the relinquished MACRS property, taking into account the applicable convention of the relinquished MACRS property and replacement MACRS property, depreciation is not allowable during the period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property. The recovery period for the replacement MACRS property is suspended during this period. For purposes of paragraph (c)(5)(ii) of this section, only the depreciable exchanged basis of the replacement MACRS property is taken into account for calculating the amount in paragraph (c)(5)(ii)(B)(*2*) of this section if the year of replacement is a taxable year subsequent to the year of disposition.

(B) *Allowable depreciation for a qualified intermediary*. [Reserved].

(v) *Remaining recovery period*. The remaining recovery period of the replacement MACRS property is determined as of the beginning of the year of disposition of the relinquished MACRS property. For purposes of determining the remaining recovery period of the replacement MACRS property, the replacement MACRS property is deemed to have been originally placed in service under the convention determined under paragraph (c)(4)(v) of this section but at the time the relinquished MACRS property was deemed to be placed in service under the convention that applied to it when it was placed in service.

(6) *Examples*. The application of this paragraph (c) is illustrated by the following examples:

Example 1. A1, a calendar-year taxpayer, exchanges Building M, an office building, for Building N, a warehouse in a like-kind exchange. Building M is relinquished in July 2004 and Building N is acquired and placed in service in October 2004. A1 did not make any elections under section 168 for either Building M or Building N. The unadjusted depreciable basis of Building M was $4,680,000 when placed in service in July 1997. Since the recovery period and depreciation method prescribed under section 168 for Building N (39 years, straight line method) are the same as the recovery period and depreciation method prescribed under section 168 for Building M (39 years, straight line method), Building N is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, Building M. Applying the applicable convention, Building M is deemed disposed of on July 15, 2004, and Building N is placed in service on October 15, 2004. Thus, Building N will be depreciated using the straight line method over a remaining recovery period of 32 years beginning in October 2004 (the remaining recovery period of 32 years and 6.5 months at the beginning of 2004, less the 6.5 months of depreciation taken prior to the disposition of the exchanged MACRS property (Building M) in 2004). For 2004, the year in which the transaction takes place, the depreciation allowance for Building M is ($120,000)(6.5/12) which equals $65,000. The depreciation allowance for Building N for 2004 is ($120,000)(2.5/12) which equals $25,000. For 2005 and subsequent years, Building N is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, Building M. Thus, the depreciation allowance for Building N is the same as Building M, namely $10,000 per month.

Example 2. B, a calendar-year taxpayer, placed in service Bridge P in January 1998. Bridge P is depreciated using the half-year convention. In January 2004, B exchanges Bridge P for Building Q, an apartment building, in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, B decided to apply §1.168(i)–6 to the exchange of Bridge P for Building Q, the replacement MACRS property. B did not make any elections under section 168 for either Bridge P or Building Q. Since the recovery period prescribed under section 168 for Building Q (27.5 years) is longer than that of Bridge P (15 years), Building Q is depreciated as if it had originally been placed in service in July 1998 and disposed of in July 2004 using a 27.5 year recovery period. Additionally, since the depreciation method prescribed under section 168 for Building Q (straight line method) is less accelerated than that of Bridge P (150-percent declining balance method), then the depreciation allowance for Building Q is computed using the straight line method. Thus, when Building Q is acquired and placed in service in 2004, its basis is depreciated over the remaining 21.5 year recovery period using the straight line method of depreciation and the mid-month convention beginning in July 2004.

Example 3. C, a calendar-year taxpayer, placed in service Building R, a restaurant, in January 1996. In January 2004, C exchanges Building R for Tower S, a radio transmitting tower, in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, C decided to apply §1.168(i)–6 to the exchange of Building R for Tower S, the replacement MACRS property. C did not make any elections under section 168 for either Building R or Tower S. Since the recovery period prescribed under section 168 for Tower S (15 years) is shorter than that of Building R (39 years), Tower S is depreciated over the remaining recovery period of Building R. Additionally, since the depreciation method prescribed under section 168 for Tower S (150% declining balance method) is more accelerated than that of Building R (straight line method), then the depreciation allowance for Tower S is also computed using the same depreciation method as Building R. Thus, Tower S is depreciated over the remaining 31 year recovery period of Building R using the straight line method of depreciation and the

mid-month convention. Alternatively, C may elect under paragraph (i) of this section to treat Tower S as though it is placed in service in January 2004. In such case, C uses the applicable recovery period, depreciation method, and convention prescribed under section 168 for Tower S.

Example 4. (i) In February 2002, D, a calendar-year taxpayer and manufacturer of rubber products, acquired for $60,000 and placed in service Asset T (a special tool) and depreciated Asset T using the straight line method election under section 168(b)(5) and the mid-quarter convention over its 3-year recovery period. D elected not to deduct the additional first year depreciation for 3-year property placed in service in 2002. In June 2004, D exchanges Asset T for Asset U (not a special tool) in a like-kind exchange. D elected not to deduct the additional first year depreciation for 7-year property placed in service in 2004. Since the recovery period prescribed under section 168 for Asset U (7 years) is longer than that of Asset T (3 years), Asset U is depreciated as if it had originally been placed in service in February 2002 using a 7-year recovery period. Additionally, since the depreciation method prescribed under section 168 for Asset U (200-percent declining balance method) is more accelerated than that of Asset T (straight line method) at the time of disposition, the depreciation allowance for Asset U is computed using the straight line method. Asset U is depreciated over its remaining recovery period of 4.75 years using the straight line method of depreciation and the mid-quarter convention.

(ii) The 2004 depreciation allowance for Asset T is $7,500 ($20,000 allowable depreciation deduction for 2004) × 4.5 months ÷ 12).

(iii) The depreciation rate in 2004 for Asset U is 0.1951 (1 ÷ 5.125 years (the length of the applicable recovery period remaining as of the beginning of 2004)). Therefore, the depreciation allowance for Asset U in 2004 is $2,744 (0.1951 × $22,500 (the sum of the $15,000 depreciable exchanged basis of Asset U ($22,500 adjusted depreciable basis at the beginning of 2004 for Asset T, less the $7,500 depreciation allowable for Asset T for 2004) and the $7,500 depreciation allowable for Asset T for 2004) × 7.5 months ÷ 12).

Example 5. The facts are the same as in *Example 4* except that D exchanges Asset T for Asset U in June 2005, in a like-kind exchange. Under these facts, the remaining recovery period of Asset T at the beginning of 2005 is 1.5 months and, as a result, is less than the 5-month period between the beginning of 2005 (year of disposition) and June 2005 (time of disposition). Accordingly, pursuant to paragraph (c)(5)(i)(B) of this section, the 2005 depreciation allowance for Asset T is $2,500 ($2,500 adjusted depreciable basis at the beginning of 2005 ($60,000 original basis minus $17,500 depreciation deduction for 2002 minus $20,000 depreciation deduction for 2003 minus $20,000 depreciation deduction for 2004)). Because the exchanged basis of asset U is $0.00 no depreciation is allowable for asset U.

Example 6. On January 1, 2004, E, a calendar-year taxpayer, acquired and placed in service Canopy V, a gas station canopy. The purchase price of Canopy V was $60,000. On August 1, 2004, Canopy V was destroyed in a hurricane and was therefore no longer usable in E's business. On October 1, 2004, as part of the involuntary conversion, E acquired and placed in service new Canopy W with the insurance proceeds E received due to the loss of Canopy V. E elected not to deduct the additional first year depreciation for 5-year property placed in service in 2004. E depreciates both canopies under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. No depreciation deduction is allowable for Canopy V. The depreciation deduction allowable for Canopy W for 2004 is $12,000 ($60,000 × the annual depreciation rate of .40 × ½ year). For 2005, the depreciation deduction for Canopy W is $19,200 ($48,000 adjusted basis x the annual depreciation rate of .40).

Example 7. The facts are the same as in *Example 6*, except that E did not make the election out of the additional first year depreciation for 5-year property placed in service in 2004. E depreciates both canopies under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. No depreciation deduction is allowable for Canopy V. For 2004, E is allowed a 50-percent additional first year depreciation deduction of $30,000 for Canopy W (the unadjusted depreciable basis of $60,000 multiplied by .50), and a regular MACRS depreciation deduction of $6,000 for Canopy W (the depreciable exchanged basis of $30,000 multiplied by the annual depreciation rate of .40 × ½ year). For 2005, E is allowed a regular MACRS depreciation deduction of $9,600 for Canopy W (the depreciable exchanged basis of $24,000 ($30,000 minus regular 2003 depreciation of $6,000) multiplied by the annual depreciation rate of .40).

Example 8. In January 2001, F, a calendar-year taxpayer, places in service a paved parking lot, Lot W, and begins depreciating Lot W over its 15-year recovery period. F's unadjusted depreciable basis in Lot W is $1,000x. On April 1, 2004, F disposes of Lot W in a like-kind exchange for Building X, which is nonresidential real property. Lot W is depreciated using the 150 percent declining balance method and the half-year convention. Building X is depreciated using the straight-line method with a 39-year recovery period and using the mid-month convention. Both Lot W and Building X were in service at the time of the exchange. Because Lot W was depreciated using the half-year convention, it is deemed to have been placed in service on July 1, 2001, the first day of the second half of 2001, and to have been disposed of on July 1, 2004, the first day of the second half of 2004. To determine the remaining recovery period of Building X at the time of replacement, Building X is deemed to have been placed in service on July 1, 2001, and removed from service on July 1, 2004. Thus, Building X is deemed to have been in service, at the time of replacement, for 3 years (36 months=5.5 months in 2001 + 12 months in 2002 + 12 months in 2003 + 6.5 months in 2004) and its remaining recovery period is 36 years (39 - 3). Because Building X is deemed to be placed in service at the time of replacement, July 1, 2004, the first day of the second half of 2004, Building X is depreciated for 5.5 months in 2004. However, at the beginning of the year of replacement the remaining recovery period for Building X is 36 years and 6.5 months (39 years - 2 years and 5.5 months (5.5 months in 2001 + 12 months in 2002 + 12 months in 2003)). The depreciation rate for building X for 2004 is 0.02737 (= 1/(39-2-5.5/12)). For 2005, the depreciation rate for Building X is 0.02814 (= 1/(39-3-5.5/12)).

Example 9. The facts are the same as in *Example 8*. F did not make the election under paragraph (i) of this section for Building Y in the initial exchange. In January 2006, F exchanges Building Y for Building Z, an office building, in a like-kind exchange. F did not make any elections under section 168 for either Building Y or Building Z. Since the recovery period prescribed for Building Y as a result of the initial exchange (39 years) is longer than that of Building Z (27.5 years), Building Z is depreciated over the remaining 33 years of the recovery period of Building Y. The depreciation methods are the same for both Building Y and Building Z so F's exchanged basis in Building Z is depreciated over 33 years, using the straight-line method and the mid-month convention, beginning in January 2006. Alternatively, F could have made the election under paragraph (i) of this section. If F makes such election, Building Z is treated as placed in service by F when acquired in January 2006 and F would recover its exchanged basis in Building Z over 27.5 years, using the straight line method and the mid-month convention, beginning in January 2006.

(d) *Special rules for determining depreciation allowances*—(1) *Excess basis*—(i) *In general*. Any excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer in the year of replacement. Thus, the depreciation allowances for the depreciable excess basis are determined by using the applicable recovery period, depreciation method, and convention prescribed under section 168 for the property at the time of replacement. However, if replacement MACRS property is disposed of during the same taxable year the relinquished MACRS property is placed in service by the acquiring taxpayer, no depreciation deduction is allowable for either MACRS property. See paragraph (g) of this section regarding the application of section 179. See paragraph (h) of this section regarding the application of section 168(k) or 1400L(b).

(ii) *Example*. The application of this paragraph (d)(1) is illustrated by the following example:

Example. In 1989, G placed in service a hospital. On January 16, 2004, G exchanges this hospital plus $2,000,000 cash for an office building in a like-kind exchange. On January 16, 2004, the hospital has an adjusted depreciable basis of $1,500,000. After the exchange, the basis of the office building is $3,500,000. Pursuant to paragraph (k)(2)(i) of this section, G decided to apply §1.168(i)–6 to the exchange of the hospital for the office building, the replacement MACRS property. The depreciable exchanged basis of the office building is depreciated in accordance with paragraph (c) of this section. The depreciable excess basis of $2,000,000 is treated as

being placed in service by G in 2004 and, as a result, is depreciated using the applicable depreciation method, recovery period, and convention prescribed for the office building under section 168 at the time of replacement.

(2) *Depreciable and nondepreciable property*—(i) If land or other nondepreciable property is acquired in a like-kind exchange for, or as a result of an involuntary conversion of, depreciable property, the land or other nondepreciable property is not depreciated. If both MACRS and nondepreciable property are acquired in a like-kind exchange for, or as part of an involuntary conversion of, MACRS property, the basis allocated to the nondepreciable property (as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b)) is not depreciated and the basis allocated to the replacement MACRS property (as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b)) is depreciated in accordance with this section.

(ii) If MACRS property is acquired, or if both MACRS and nondepreciable property are acquired, in a like-kind exchange for, or as part of an involuntary conversion of, land or other nondepreciable property, the basis in the replacement MACRS property that is attributable to the relinquished nondepreciable property is treated as though the replacement MACRS property is placed in service by the acquiring taxpayer in the year of replacement. Thus, the depreciation allowances for the replacement MACRS property are determined by using the applicable recovery period, depreciation method, and convention prescribed under section 168 for the replacement MACRS property at the time of replacement. See paragraph (g) of this section regarding the application of section 179. See paragraph (h) of this section regarding the application of section 168(k) or 1400L(b).

(3) *Depreciation limitations for automobiles*—(i) *In general*. Depreciation allowances under section 179 and section 167 (including allowances under sections 168 and 1400L(b)) for a passenger automobile, as defined in section 280F(d)(5), are subject to the limitations of section 280F(a). The depreciation allowances for a passenger automobile that is replacement MACRS property (replacement MACRS passenger automobile) generally are limited in any taxable year to the replacement automobile section 280F limit for the taxable year. The taxpayer's basis in the replacement MACRS passenger automobile is treated as being comprised of two separate components. The first component is the exchanged basis and the second component is the excess basis, if any. The depreciation allowances for a passenger automobile that is relinquished MACRS property (relinquished MACRS passenger automobile) for the taxable year generally are limited to the relinquished automobile section 280F limit for that taxable year. In the year of disposition the sum of the depreciation deductions for the relinquished MACRS passenger automobile and the replacement MACRS passenger automobile may not exceed the replacement automobile section 280F limit unless the taxpayer makes the election under §1.168(i)–6(i). For purposes of this paragraph (d)(3), the following definitions apply:

(A) *Replacement automobile section 280F limit* is the limit on depreciation deductions under section 280F(a) for the taxable year based on the time of replacement of the replacement MACRS passenger automobile (including the effect of any elections under section 168(k) or section 1400L(b), as applicable).

(B) *Relinquished automobile section 280F limit* is the limit on depreciation deductions under section 280F(a) for the taxable year based on when the relinquished MACRS passenger automobile was placed in service by the taxpayer.

(ii) *Order in which limitations on depreciation under section 280F(a) are applied*. Generally, depreciation deductions allowable under section 280F(a) reduce the basis in the relinquished MACRS passenger automobile and the exchanged basis of the replacement MACRS passenger automobile, before the excess basis of the replacement MACRS passenger automobile is reduced. The depreciation deductions for the relinquished MACRS passenger automobile in the year of disposition and the replacement MACRS passenger automobile in the year of replacement and each subsequent taxable year are allowable in the following order:

(A) The depreciation deduction allowable for the relinquished MACRS passenger automobile as determined under paragraph (c)(5)(i) of this section for the year of disposition to the extent of the smaller of the replacement automobile section 280F limit and the relinquished automobile section 280F limit, if the year of disposition is the year of replacement. If the year of replacement is a taxable year subsequent to the year of disposition, the depreciation deduction allowable for the relinquished MACRS passenger automobile for the year of disposition is limited to the relinquished automobile section 280F limit.

(B) The additional first year depreciation allowable on the remaining exchanged basis (remaining carryover basis as determined under §1.168(k)–1(f)(5) or §1.1400L(b)–1(f)(5), as applicable) of the replacement MACRS passenger automobile, as determined under §1.168(k)–1(f)(5) or §1.1400L(b)–1(f)(5), as applicable, to the extent of the excess of the replacement automobile section 280F limit over the amount allowable under paragraph (d)(3)(ii)(A) of this section.

(C) The depreciation deduction allowable for the taxable year on the depreciable exchanged basis of the replacement MACRS passenger automobile determined under paragraph (c) of this section to the extent of any excess over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A) and (B) of this section of the smaller of the replacement automobile section 280F limit and the relinquished automobile section 280F limit.

(D) Any section 179 deduction allowable in the year of replacement on the excess basis of the replacement MACRS passenger automobile to the extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), and (C) of this section.

(E) The additional first year depreciation allowable on the remaining excess basis of the replacement MACRS passenger automobile, as determined under §1.168(k)–1(f)(5) or §1.1400L(b)–1(f)(5), as applicable, to the extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), (C), and (D) of this section.

(F) The depreciation deduction allowable under paragraph (d) of this section for the depreciable excess basis of the replacement MACRS passenger automobile to the

extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), (C), (D), and (E) of this section.

(iii) *Examples*. The application of this paragraph (d)(3) is illustrated by the following examples:

Example 1. H, a calendar-year taxpayer, acquired and placed in service Automobile X in January 2000 for $30,000 to be used solely for H's business. In December 2003, H exchanges, in a like-kind exchange, Automobile X plus $15,000 cash for new Automobile Y that will also be used solely in H's business. Automobile Y is 50-percent bonus depreciation property for purposes of section 168(k)(4). Both automobiles are depreciated using the double declining balance method, the half-year convention, and a 5-year recovery period. Pursuant to §1.168(k)–1(g)(3)(ii) and paragraph (k)(2)(i) of this section, H decided to apply §1.168(i)–6 to the exchange of Automobile X for Automobile Y, the replacement MACRS property. The relinquished automobile section 280F limit for 2003 for Automobile X is $1,775. The replacement automobile section 280F limit for Automobile Y is $10,710. The exchanged basis for Automobile Y is $17,315 ($30,000 less total depreciation allowable of $12,685 (($3,060 for 2000, $4,900 for 2001, $2,950 for 2002, and $1,775 for 2003)). Without taking section 280F into account, the additional first year depreciation deduction for the remaining exchanged basis is $8,658 ($17,315 x 0.5). Because this amount is less than $8,935 ($10,710 (the replacement automobile section 280F limit for 2003 for Automobile Y) - $1,775 (the depreciation allowable for Automobile X for 2003)), the additional first year depreciation deduction for the exchanged basis is $8,658. No depreciation deduction is allowable in 2003 for the depreciable exchanged basis because the depreciation deductions taken for Automobile X and the remaining exchanged basis exceed the exchanged automobile section 280F limit. An additional first year depreciation deduction of $277 is allowable for the excess basis of $15,000 in Automobile Y. Thus, at the end of 2003 the adjusted depreciable basis in Automobile Y is $23,379 comprised of adjusted depreciable exchanged basis of $8,657 ($17,315 (exchanged basis) – $8,658 (additional first year depreciation for exchanged basis)) and of an adjusted depreciable excess basis of $14,723 ($15,000 (excess basis) - $277 (additional first year depreciation for 2003)).

Example 2. The facts are the same as in *Example 1*, except that H used Automobile X only 75 percent for business use. As such, the total allowable depreciation for Automobile X is reduced to reflect that the automobile is only used 75 percent for business. The total allowable depreciation of Automobile X is $9,513.75 ($2,295 for 2000 ($3,060 limit x .75), $3,675 for 2001 ($4,900 limit x .75), $2,212.50 for 2002 ($2,950 limit x .75), and $1,331.25 for 2003 ($1,775 limit x .75). However, under §1.280F–2T(g)(2)(ii)(A), the exchanged basis is reduced by the excess (if any) of the depreciation that would have been allowable if the exchanged automobile had been used solely for business over the depreciation that was allowable in those years. Thus, the exchanged basis, for purposes of computing depreciation, for Automobile Y is $17,315.

Example 3. The facts are the same as in *Example 1*, except that H placed in service Automobile X in January 2002, and H elected not to claim the additional first year depreciation deduction for 5-year property placed in service in 2002 and 2003. The relinquished automobile section 280F limit for Automobile X for 2003 is $4,900. Because the replacement automobile section 280F limit for 2003 for Automobile Y ($3,060) is less than the relinquished automobile section 280F limit for Automobile X for 2003 and is less than $5,388 (($30,000 (cost) - $3,060 (depreciation allowable for 2002)) x 0.4 x 6/12), the depreciation that would be allowable for Automobile X (determined without regard to section 280F) in the year of disposition, the depreciation for Automobile X in the year of disposition is limited to $3,060. For 2003 no depreciation is allowable for the excess basis and the exchanged basis in Automobile Y.

Example 4. AB, a calendar-year taxpayer, purchased and placed in service Automobile X1 in February 2000 for $10,000. X1 is a passenger automobile subject to section 280F(a) and is used solely for AB's business. AB depreciated X1 using a 5-year recovery period, the double declining balance method, and the half-year convention. As of January 1, 2003, the adjusted depreciable basis of X1 was $2,880 ($10,000 original cost minus $2,000 depreciation deduction for 2000, minus $3,200 depreciation deduction for 2001, and $1,920 depreciation deduction for 2002). In November 2003, AB exchanges, in a like-kind exchange, Automobile X1 plus $14,000 cash for new Automobile Y1 that will be used solely in AB's business. Automobile Y1 is 50-percent bonus depreciation property for purposes of section 168(k)(4) and qualifies for the expensing election under section 179. Pursuant to paragraph §1.168(k)–1(g)(3)(ii) and paragraph (k)(2)(i) of this section, AB decided to apply §1.168(i)–6 to the exchange of Automobile X1 for Automobile Y1, the replacement MACRS property. AB also makes the election under section 179 for the excess basis of Automobile Y1. AB depreciates Y1 using a five-year recovery period, the double declining balance method and the half-year convention. For 2003, the relinquished automobile section 280F limit for Automobile X1 is $1,775 and the replacement automobile section 280F limit for 2003 for Automobile Y1 is $10,710.

(i) The 2003 depreciation deduction for Automobile X1 is $576. The depreciation deduction calculated for X1 is $576 (the adjusted depreciable basis of Automobile X1 at the beginning of 2003 of $2,880 × 40% × ½ year), which is less than the relinquished automobile section 280F limit and the replacement automobile section 280F limit.

(ii) The additional first year depreciation deduction for the exchanged basis is $1,152. The additional first year depreciation deduction of $1,152 (remaining exchanged basis of $2,304 ($2,880 adjusted basis of Automobile X1 at the beginning of 2003 minus $576) × 0.5)) is less than the replacement automobile section 280F limit minus $576.

(iii) AB's MACRS depreciation deduction allowable in 2003 for the remaining exchanged basis of $1,152 is $47 (the relinquished automobile section 280F limit of $1,775 less the depreciation deduction of $576 taken for Automobile X1 less the additional first year depreciation deduction of $1,152 taken for the exchanged basis) which is less than the depreciation deduction calculated for the depreciable exchanged basis.

(iv) For 2003, AB takes a $1,400 section 179 deduction for the excess basis of Automobile Y1. AB must reduce the excess basis of $14,000 by the section 179 deduction of $1,400 to determine the remaining excess basis of $12,600.

(v) For 2003, AB is allowed a 50-percent additional first year depreciation deduction of $6,300 (the remaining excess basis of $12,600 multiplied by .50).

(vi) For 2003, AB's depreciation deduction for the depreciable excess basis is limited to $1,235. The depreciation deduction computed without regard to the replacement automobile section 280F limit is $1,260 ($6,300 depreciable excess basis x 0.4 x 6/12). However the depreciation deduction for the depreciable excess basis is limited to $1,235 ($10,710 (replacement automobile section 280F limit) - $576 (depreciation deduction for Automobile X1) - $1,152 (additional first year depreciation deduction for the exchanged basis) - $47 (depreciation deduction for exchanged basis) $1,400 (section 179 deduction) - $6,300 (additional first year depreciation deduction for remaining excess basis)).

(4) *Involuntary conversion for which the replacement MACRS property is acquired and placed in service before disposition of relinquished MACRS property*. If, in an involuntary conversion, a taxpayer acquires and places in service the replacement MACRS property before the date of disposition of the relinquished MACRS property, the taxpayer depreciates the unadjusted depreciable basis of the replacement MACRS property under section 168 beginning in the taxable year when the replacement MACRS property is placed in service by the taxpayer and by using the applicable depreciation method, recovery period, and convention prescribed under section 168 for the replacement MACRS property at the placed-in-service date. However, at the time of disposition of the relinquished MACRS property, the taxpayer determines the exchanged basis and the excess basis of the replacement MACRS property and begins to depreciate the depreciable exchanged basis of the replacement MACRS property in accordance with paragraph (c) of this section. The depreciable excess basis of the replacement MACRS property continues to be depreciated by the taxpayer in accordance with the first sentence of this paragraph (d)(4). Further, in the year of disposition of the relinquished MACRS property, the taxpayer must include in taxable income the excess of the depreciation deductions allowable on the unadjusted depreciable basis of the replacement MACRS property over the depreciation deductions that

would have been allowable to the taxpayer on the depreciable excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer (taking into account the applicable convention) to the time of disposition of the relinquished MACRS property. However, see §1.168(k)–1(f)(5)(v) for replacement MACRS property that is qualified property or 50-percent bonus depreciation property and §1.1400L(b)–1(f)(5) for replacement MACRS property that is qualified New York Liberty Zone property.

(e) *Use of optional depreciation tables*—(1) *Taxpayer not bound by prior use of table*. If a taxpayer used an optional depreciation table for the relinquished MACRS property, the taxpayer is not required to use an optional table for the depreciable exchanged basis of the replacement MACRS property. Conversely, if a taxpayer did not use an optional depreciation table for the relinquished MACRS property, the taxpayer may use the appropriate table for the depreciable exchanged basis of the replacement MACRS property. If a taxpayer decides not to use the table for the depreciable exchanged basis of the replacement MACRS property, the depreciation allowance for this property for the year of replacement and subsequent taxable years is determined under paragraph (c) of this section. If a taxpayer decides to use the optional depreciation tables, no depreciation deduction is allowable for MACRS property placed in service by the acquiring taxpayer and subsequently exchanged or involuntarily converted by such taxpayer in the same taxable year, and, if, during the same taxable year, MACRS property is placed in service by the acquiring taxpayer, exchanged or involuntarily converted by such taxpayer, and the replacement MACRS property is disposed of by such taxpayer, no depreciation deduction is allowable for either MACRS property.

(2) *Determination of the depreciation deduction*—(i) *Relinquished MACRS property*. In the year of disposition, the depreciation allowance for the relinquished MACRS property is computed by multiplying the unadjusted depreciable basis (less the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b), as applicable) of the relinquished MACRS property by the annual depreciation rate (expressed as a decimal equivalent) specified in the appropriate table for the recovery year corresponding to the year of disposition. This product is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of the exchange or involuntary conversion (taking into account the applicable convention) and the denominator of which is 12. However, if the year of disposition is less than 12 months, the depreciation allowance determined under this paragraph (e)(2)(i) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15, 1989–1 C.B. 816, and §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Replacement MACRS property*—(A) *Determination of the appropriate optional depreciation table*. If a taxpayer chooses to use the appropriate optional depreciation table for the depreciable exchanged basis, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined by choosing the optional depreciation table that corresponds to the recovery period, depreciation method, and convention of the replacement MACRS property determined under paragraph (c) of this section.

(B) *Calculating the depreciation deduction for the replacement MACRS property*. (*1*) The depreciation deduction for the taxable year is computed by first determining the appropriate recovery year in the table identified under paragraph (e)(2)(ii)(A) of this section. The appropriate recovery year for the year of replacement is the same as the recovery year for the year of disposition, regardless of the taxable year in which the replacement property is acquired. For example, if the recovery year for the year of disposition would have been year 4 in the table that applied before the disposition of the relinquished MACRS property, then the recovery year for the year of replacement is Year 4 in the table identified under paragraph (e)(2)(ii)(A) of this section.

(*2*) Next, the annual depreciation rate (expressed as a decimal equivalent) for each recovery year is multiplied by a transaction coefficient. The transaction coefficient is the formula (1 / (1 - x)) where x equals the sum of the annual depreciation rates from the table identified under paragraph (e)(2)(ii)(A) of this section (expressed as a decimal equivalent) corresponding to the replacement MACRS property (as determined under paragraph (e)(2)(ii)(A) of this section) for the taxable years beginning with the placed-in-service year of the relinquished MACRS property through the taxable year immediately prior to the year of disposition. The product of the annual depreciation rate and the transaction coefficient is multiplied by the depreciable exchanged basis (taking into account paragraph (e)(2)(i) of this section). In the year of replacement, this product is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service by the acquiring taxpayer during the year of replacement (taking into account the applicable convention) and the denominator of which is 12. However, if the year of replacement is the year the relinquished MACRS property is placed in service by the acquiring taxpayer, the preceding sentence does not apply. In addition, if the year of replacement is less than 12 months, the depreciation allowance determined under paragraph (e)(2)(ii) of this section must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15, 1989–1 C.B. 816, and §601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Unrecovered basis*. If the replacement MACRS property would have unrecovered depreciable basis after the final recovery year (for example, due to a deferred exchange), the unrecovered basis is an allowable depreciation deduction in the taxable year that corresponds to the final recovery year unless the unrecovered basis is subject to a depreciation limitation such as section 280F.

(3) *Excess basis*. As provided in paragraph (d)(1) of this section, any excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer at the time of replacement. Thus, if the taxpayer chooses to use the appropriate optional depreciation table for the depreciable excess basis in the replacement MACRS property, the depreciation allowances for the depreciable excess basis are determined by multiplying the depreciable excess basis by the annual depreciation rate (expressed as a

decimal equivalent) specified in the appropriate table for each taxable year. The appropriate table for the depreciable excess basis is based on the depreciation method, recovery period, and convention applicable to the depreciable excess basis under section 168 at the time of replacement. However, If the year of replacement is less than 12 months, the depreciation allowance determined under this paragraph (e)(3) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15, 1989–1 C.B. 816, and §601.601(d)(2)(ii)(*b*) of this chapter).

(4) *Examples*. The application of this paragraph (e) is illustrated by the following examples:

Example 1. J, a calendar-year taxpayer, acquired 5-year property for $10,000 and placed it in service in January 2001. J uses the optional tables to depreciate the property. J uses the half-year convention and did not make any elections for the property. In December 2003, J exchanges the 5-year property for used 7-year property in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, J decided to apply §1.168(i)–6 to the exchange of the 5-year property for the 7-year property, the replacement MACRS property. The depreciable exchanged basis of the 7-year property equals the adjusted depreciable basis of the 5-year property at the time of disposition of the relinquished MACRS property, namely $3,840 ($10,000 less $2,000 depreciation in 2001, $3,200 depreciation in 2002, and $960 depreciation in 2003). J must first determine the appropriate optional depreciation table pursuant to paragraph (c) of this section. Since the replacement MACRS property has a longer recovery period and the same depreciation method as the relinquished MACRS property, J uses the optional depreciation table corresponding to a 7-year recovery period, the 200% declining balance method, and the half-year convention (because the 5-year property was depreciated using a half-year convention). Had the replacement MACRS property been placed in service in the same taxable year as the placed-in-service year of the relinquished MACRS property, the depreciation allowance for the replacement MACRS property for the year of replacement would be determined using recovery year 3 of the optional table. The depreciation allowance equals the depreciable exchanged basis ($3,840) multiplied by the annual depreciation rate for the current taxable year (.1749 for recovery year 3) as modified by the transaction coefficient [1 / (1 - (.1429 + .2449))] which equals 1.6335. Thus, J multiplies $3,840, its depreciable exchanged basis in the replacement MACRS property, by the product of .1749 and 1.6335, and then by one-half, to determine the depreciation allowance for 2003, $549. For 2004, J multiples its depreciable exchanged basis in the replacement MACRS property determined at the time of replacement of $3,840 by the product of the modified annual depreciation rate for the current taxable year (.1249 for recovery year 4) and the transaction coefficient (1.6335) to determine its depreciation allowance of $783.

Example 2. K, a calendar-year taxpayer, acquired used Asset V for $100,000 and placed it in service in January 1999. K depreciated Asset V under the general depreciation system of section 168(a) by using a 5-year recovery period, the 200-percent declining balance method of depreciation, and the half-year convention. In December 2003, as part of the involuntary conversion, Asset V is involuntarily converted due to an earthquake. In October 2005, K purchases used Asset W with the insurance proceeds from the destruction of Asset V and places Asset W in service to replace Asset V. Pursuant to paragraph (k)(2)(i) of this section, K decided to apply §1.168(i)–6 to the involuntary conversion of Asset V with the replacement of Asset W, the replacement MACRS property. If Asset W had been placed in service when Asset V was placed in service, it would have been depreciated using a 7-year recovery period, the 200-percent declining balance method, and the half-year convention. K uses the optional depreciation tables to depreciate Asset V and Asset W. For 2003 (recovery year 5 on the optional table), the depreciation deduction for Asset V is $5,760 ((0.1152)($100,000)(1/2)). Thus, the adjusted depreciable basis of Asset V at the time of replacement is $11,520 ($100,000 less $20,000 depreciation in 1999, $32,000 depreciation in 2000, $19,200 depreciation in 2001, $11,520 depreciation in 2002, and $5,760 depreciation in 2003). Under the table that applied to Asset V, the year of disposition was recovery year 5 and the depreciation deduction was determined under the straight line method. The table that applies for Asset W is the table that applies the straight line depreciation method, the half-year convention, and a 7-year recovery period. The appropriate recovery year under this table is recovery year 5. The depreciation deduction for Asset W for 2005 is $1,646 (($11,520)(0.1429)(1/(1–0.5))(1/2)). Thus, the depreciation deduction for Asset W in 2006 (recovery year 6) is $3,290 ($11,520)(0.1428)(1/(1–0.5)). The depreciation deduction for 2007 (recovery year 7) is $3,292 (($11,520)(.1429)(1/(1-.5))). The depreciation deduction for 2008 (recovery year 8) is $3,292 ($11,520 less allowable depreciation for Asset W for 2005 through 2007 ($1,646 + $3,290 + $3,292)).

Example 3. L, a calendar-year taxpayer, placed in service used Computer X in January 2002 for $5,000. L depreciated Computer X under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Computer X is destroyed in a fire in March 2004. For 2004, the depreciation deduction allowable for Computer X equals $480 ([($5,000)(.1920)] x (1/2)). Thus, the adjusted depreciable basis of Computer X was $1,920 when it was destroyed ($5,000 unadjusted depreciable basis less $1,000 depreciation for 2002, $1,600 depreciation for 2003, and $480 depreciation for 2004). In April 2004, as part of the involuntary conversion, L acquired and placed in service used Computer Y with insurance proceeds received due to the loss of Computer X. Computer Y will be depreciated using the same depreciation method, recovery period, and convention as Computer X. L elected to use the optional depreciation tables to compute the depreciation allowance for Computer X and Computer Y. The depreciation deduction allowable for 2004 for Computer Y equals $384 ([$1,920 x (.1920)(1/(1-.52))] x (1/2)).

(f) *Mid-quarter convention*. For purposes of applying the 40-percent test under section 168(d) and the regulations under section 168(d), the following rules apply:

(1) *Exchanged basis*. If, in a taxable year, MACRS property is placed in service by the acquiring taxpayer (but not as a result of a like-kind exchange or involuntary conversion) and—

(i) In the same taxable year, is disposed of by the acquiring taxpayer in a like-kind exchange or an involuntary conversion and replaced by the acquiring taxpayer with replacement MACRS property, the exchanged basis (determined without any adjustments for depreciation deductions during the taxable year) of the replacement MACRS property is taken into account in the year of replacement in the quarter the relinquished MACRS property was placed in service by the acquiring taxpayer; or

(ii) In the same taxable year, is disposed of by the acquiring taxpayer in a like-kind exchange or an involuntary conversion, and in a subsequent taxable year is replaced by the acquiring taxpayer with replacement MACRS property, the exchanged basis (determined without any adjustments for depreciation deductions during the taxable year) of the replacement MACRS property is taken into account in the year of replacement in the quarter the replacement MACRS property was placed in service by the acquiring taxpayer; or

(iii) In a subsequent taxable year, disposed of by the acquiring taxpayer in a like-kind exchange or involuntary conversion, the exchanged basis of the replacement MACRS property is not taken into account in the year of replacement.

(2) *Excess basis*. Any excess basis is taken into account in the quarter the replacement MACRS property is placed in service by the acquiring taxpayer.

(3) *Depreciable property acquired for nondepreciable property*. Both the exchanged basis and excess basis of the replacement MACRS property described in paragraph (d)(2)(ii) of this section (depreciable property acquired for nondepreciable property), are taken into account for determining whether the mid-quarter convention applies in the year of replacement.

(g) *Section 179 election*. In applying the section 179 election, only the excess basis, if any, in the replacement MACRS property is taken into account. If the replacement MACRS property is described

in paragraph (d)(2)(ii) of this section (depreciable property acquired for nondepreciable property), only the excess basis in the replacement MACRS property is taken into account.

(h) *Additional first year depreciation deduction*. See §1.168(k)–1(f)(5) (for qualified property or 50-percent bonus depreciation property) and §1.1400L(b)–1(f)(5) (for qualified New York Liberty Zone property).

(i) *Elections*—(1) *Election not to apply this section*. A taxpayer may elect not to apply this section for any MACRS property involved in a like-kind exchange or involuntary conversion. An election under this paragraph (i)(1) applies only to the taxpayer making the election and the election applies to both the relinquished MACRS property and the replacement MACRS property. If an election is made under this paragraph (i)(1), the depreciation allowances for the replacement MACRS property beginning in the year of replacement and for the relinquished MACRS property in the year of disposition are not determined under this section (except as otherwise provided in this paragraph). Instead, for depreciation purposes only, the sum of the exchanged basis and excess basis, if any, in the replacement MACRS property is treated as property placed in service by the taxpayer at the time of replacement and the adjusted depreciable basis of the relinquished MACRS property is treated as being disposed of by the taxpayer at the time of disposition. While the relinquished MACRS property is treated as being disposed of at the time of disposition for depreciation purposes, the election not to apply this section does not affect the application of sections 1031 and 1033 (for example, if a taxpayer does not make the election under this paragraph (i)(1) and does not recognize gain or loss under section 1031, this result would not change if the taxpayer chose to make the election under this paragraph (i)(1)). In addition, the election not to apply this section does not affect the application of sections 1245 and 1250 to the relinquished MACRS property. Paragraphs (c)(5)(i) (determination of depreciation for relinquished MACRS property in the year of disposition), (c)(5)(iii) (rules for deferred transactions), (g) (section 179 election), and (h) (additional first year depreciation deduction) of this section apply to property to which this paragraph (i)(1) applies. See paragraph (j) of this section for the time and manner of making the election under this paragraph (i)(1).

(2) *Election to treat certain replacement property as MACRS property*. If the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), the taxpayer may elect to treat, for depreciation purposes only, the sum of the exchanged basis and excess basis, if any, of the replacement property as MACRS property that is placed in service by the taxpayer at the time of replacement. An election under this paragraph (i)(2) applies only to the taxpayer making the election and the election applies to both the relinquished property and the replacement property. If an election is made under this paragraph (i)(2), the adjusted depreciable basis of the relinquished property is treated as being disposed of by the taxpayer at the time of disposition. Rules similar to those provided in §§1.168(i)–6(b)(3) and (4) apply for purposes of determining the time of disposition and time of replacement under this paragraph (i)(2). While the relinquished property is treated as being disposed of at the time of disposition for depreciation purposes, the election under this paragraph (i)(2) does not affect the application of sections 1031 and 1033, and the application of sections 1245 and 1250 to the relinquished property. If an election is made under this paragraph (i)(2), rules similar to those provided in paragraphs (c)(5)(iii) (rules for deferred transactions), (g) (section 179 election), and (h) (additional first year depreciation deduction) of this section apply to property. Except as provided in paragraph (k)(3)(ii) of this section, a taxpayer makes the election under this paragraph (i)(2) by claiming the depreciation allowance as determined under MACRS for the replacement property on the taxpayer's timely filed (including extensions) original Federal tax return for the placed-in-service year of the replacement property as determined under this paragraph (i)(2).

(j) *Time and manner of making election under paragraph (i)(1) of this section*—(1) *In general*. The election provided in paragraph (i)(1) of this section is made separately by each person acquiring replacement MACRS property. The election is made for each member of a consolidated group by the common parent of the group, by the partnership (and not by the partners separately) in the case of a partnership, or by the S corporation (and not by the shareholders separately) in the case of an S corporation. A separate election under paragraph (i)(1) of this section is required for each like-kind exchange or involuntary conversion. The election provided in paragraph (i)(1) of this section must be made within the time and manner provided in paragraph (j)(2) and (3) of this section and may not be made by the taxpayer in any other manner (for example, the election cannot be made through a request under section 446(e) to change the taxpayer's method of accounting), except as provided in paragraph (k)(2) of this section.

(2) *Time for making election*. The election provided in paragraph (i)(1) of this section must be made by the due date (including extensions) of the taxpayer's Federal tax return for the year of replacement.

(3) *Manner of making election*. The election provided in paragraph (i)(1) of this section is made in the manner provided for on Form 4562, *Depreciation and Amortization*, and its instructions. If Form 4562 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form.

(4) *Revocation*. The election provided in paragraph (i)(1) of this section, once made, may be revoked only with the consent of the Commissioner of Internal Revenue. Such consent will be granted only in extraordinary circumstances. Requests for consent are requests for a letter ruling and must be filed with the Commissioner of Internal Revenue, Washington, DC 20224. Requests for consent may not be made in any other manner (for example, through a request under section 446(e) to change the taxpayer's method of accounting).

(k) *Effective date*—(1) *In general*. Except as provided in paragraph (k)(3) of this section, this section applies to a like-kind exchange or an involuntary conversion of MACRS property for which the time of

disposition and the time of replacement both occur after February 27, 2004.

(2) *Application to pre-effective date like-kind exchanges and involuntary conversions.* For a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may—

(i) Apply the provisions of this section. If a taxpayer's applicable Federal tax return has been filed on or before February 27, 2004, and the taxpayer has treated the replacement MACRS property as acquired, and the relinquished MACRS property as disposed of, in a like-kind exchange or an involuntary conversion, the taxpayer changes its method of accounting for depreciation of the replacement MACRS property and relinquished MACRS property in accordance with this paragraph (k)(2)(i) by following the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002–9, 2002–1 C.B. 327, and §601.601(d)(2)(ii)(*b*) of this chapter); or

(ii) Rely on prior guidance issued by the Internal Revenue Service for determining the depreciation deductions of replacement MACRS property and relinquished MACRS property (for further guidance, for example, see Notice 2000–4, 2000–1 C.B. 313, and §601.601(d)(2)(ii)(*b*) of this chapter). In relying on such guidance, a taxpayer may use any reasonable, consistent method of determining depreciation in the year of disposition and the year of replacement. If a taxpayer's applicable Federal tax return has been filed on or before February 27, 2004, and the taxpayer has treated the replacement MACRS property as acquired, and the relinquished MACRS property as disposed of, in a like-kind exchange or an involuntary conversion, the taxpayer changes its method of accounting for depreciation of the replacement MACRS property and relinquished MACRS property in accordance with this paragraph (k)(2)(ii) by following the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002–9, 2002–1 C.B. 327, and §601.601(d)(2)(ii)(*b*) of this chapter).

(3) *Like-kind exchanges and involuntary conversions where the taxpayer made the election under section 168(f)(1) for the relinquished property*—(i) *In general.* If the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), paragraph (i)(2) of this section applies to such relinquished property and replacement property for which the time of disposition and the time of replacement (both as determined under paragraph (i)(2) of this section) both occur after February 26, 2007.

(ii) *Application of paragraph (i)(2) of this section to pre-February 26, 2007, like-kind exchanges and involuntary conversions.* If the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), the taxpayer may apply paragraph (i)(2) of this section to the relinquished property and the replacement property for which the time of disposition, the time of replacement (both as determined under paragraph (i)(2) of this section), or both occur on or before February 26, 2007. If the taxpayer wants to apply paragraph (i)(2) of this section and the taxpayer's applicable Federal tax return has been filed on or before February 26, 2007, the taxpayer must change its method of accounting for depreciation of the replacement property and relinquished property in accordance with this paragraph (k)(3)(ii) by following the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002–9, 2002–1 C.B. 327, and §601.601(d)(2)(ii)(*b*) of this chapter).

§1.168(i)–6T [Removed]

Par. 13. Section 1.168(i)–6T is removed.

Par. 14. Section 1.168(k)–1 is amended as follows:

1. The second and third sentences in paragraph (f)(5)(v)(B) are revised.

2. The last sentences in Example 1(i), Example 3(i), Example 4(i), and Example 5(i) in paragraph (f)(5)(vi) are revised.

3. Paragraph (g)(3)(ii) is revised.

The revisions read as follows:

§1.168(k)–1 Additional first year depreciation.

* * * * *

(f) * * *

(5) * * *

(v) * * *

(B) * * * However, at the time of disposition of the involuntarily converted MACRS property, the taxpayer determines the exchanged basis (as defined in §1.168(i)–6(b)(7)) and the excess basis (as defined in §1.168(i)–6(b)(8)) of the acquired MACRS property and begins to depreciate the depreciable exchanged basis (as defined in §1.168(i)–6(b)(9) of the acquired MACRS property in accordance with §1.168(i)–6(c). The depreciable excess basis (as defined in §1.168(i)–6(b)(10)) of the acquired MACRS property continues to be depreciated by the taxpayer in accordance with the first sentence of this paragraph (f)(5)(v)(B).

* * * * *

(vi) * * *

Example 1. (i) * * * Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)–6(k)(2)(i), EE decided to apply §1.168(i)–6 to the involuntary conversion of Canopy V1 with the replacement of Canopy W1, the acquired MACRS property.

* * * * *

Example 3. (i) * * * Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)–6(k)(2)(i), FF decided to apply §1.168(i)–6 to the exchange of Computer X2 for Computer Y2, the acquired MACRS property.

* * * * *

Example 4. (i) * * * Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)–6(k)(2)(i), GG decided to apply §1.168(i)–6 to the exchange of Equipment X3 for Equipment Y3, the acquired MACRS property.

* * * * *

Example 5. (i) * * * Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)–6(k)(2)(i), GG decided to apply §1.168(i)–6 to the exchange

of Equipment Y3 for Equipment Z1, the acquired MACRS property.

* * * * *

(g) * * *

(3) * * *

(ii) Paragraphs (f)(5)(ii)(F)(*2*) and (f)(5)(v) of this section apply to a like-kind exchange or an involuntary conversion of MACRS property and computer software for which the time of disposition and the time of replacement both occur after February 27, 2004. For a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, see §1.168(i)–6(k)(2)(ii). For a like-kind exchange or involuntary conversion of computer software for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may rely on prior guidance issued by the Internal Revenue Service for determining the depreciation deductions of the acquired computer software and the exchanged or involuntarily converted computer software (for further guidance, see §1.168(k)–1T(f)(5) published in the **Federal Register** on September 8, 2003 (T.D. 9091, 2003–2 C.B. 939 [68 FR 53000])). In relying on such guidance, a taxpayer may use any reasonable, consistent method of determining depreciation in the year of disposition and the year of replacement.

* * * * *

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

Approved February 23, 2007.

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

(Filed by the Office of the Federal Register on February 26, 2007, 3:25 p.m., and published in the issue of the Federal Register for March 1, 2007, 72 F.R. 9245)

Section 527.—Political Organizations

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

A revenue procedure sets forth the elements of a safe harbor under section 527(1) of the Internal Revenue Code for waiver of amounts due for failure to comply with certain reporting requirements due to reasonable cause but not willful neglect. See Rev. Proc. 2007-27, page 887.

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 1.6011–1(a): General requirement of return, statement or list.
(Also: §§ 6012(a), 6020(b), 6072(a), 6151.)

Frivolous tax returns; voluntary compliance. This ruling discusses and refutes the frivolous position taken by some taxpayers that complying with the internal revenue laws is purely voluntary and that taxpayers are not legally required to file federal tax returns or pay federal tax because the filing of a tax return or the payment of tax is a matter of choice.

Rev. Rul. 2007–20

PURPOSE

The Internal Revenue Service (Service) is aware that some taxpayers assert that compliance with the internal revenue laws is purely voluntary, specifically, that they are not required to file federal tax returns or pay federal tax because the filing of a tax return or the payment of tax is a matter of choice. Taxpayers who take this position argue that the Form 1040 Series instructions provide that filing a return and paying tax are voluntary and not mandatory. Often quoting from the Supreme Court's opinion in *Flora v. United States*, 362 U.S. 145, 176 (1960), they claim that "[o]ur system of taxation is based upon voluntary assessment and payment, not upon distraint." Some of these taxpayers also contend that section 6020(b) of the Internal Revenue Code requires the Service to prepare a federal tax return for any person who does not file a return, which, according to these taxpayers, means that they are not required to file a return.

This revenue ruling emphasizes to taxpayers, promoters, and return preparers that the requirements to file a tax return and pay the tax that is due are not optional. Any position to the contrary has no merit and is frivolous.

The Service is committed to identifying taxpayers who attempt to avoid their federal tax obligations by taking frivolous positions. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through the Service's Frivolous Return Program. As part of this program, the Service determines whether taxpayers who have taken frivolous positions have filed all required tax returns, computes the correct amount of tax and interest due, and determines whether civil or criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters, and others who assist taxpayers in taking frivolous positions, and recommends whether an injunction should be sought to halt these activities. Other information about frivolous tax positions is available on the Service website at *www.irs.gov*.

ISSUE

Whether filing a tax return or paying tax is voluntary.

FACTS

Taxpayer A claims that he is not required to file a federal income tax return or pay income taxes because filing a return and paying tax are "voluntary" activities that he can legitimately opt not to do. Taxpayer A further claims that if a tax return is required, the Service must prepare it for the taxpayer.

LAW AND ANALYSIS

Effective tax administration relies on taxpayers willingly complying with the tax laws, but taxpayers do not have the right to choose whether the laws apply to them. References to a "voluntary" tax system in *Flora*, *supra*, and in Service publications, mean a system that allows taxpayers to determine, in the first instance, the correct

amount of their tax and to report their liability on appropriate returns, rather than having the government make the determinations for them. *See Hibbs v. Winn*, 542 U.S. 88, 100 n.3 (2004) ("[T]he taxpayer, not the taxing authority, is the *first* party to make the relevant calculation of income taxes owed.") (Emphasis added). "Voluntary" in this context does not mean that taxpayers may opt out of the system. As stated in *United States v. Schiff*, 876 F.2d 272, 275 (2d Cir. 1989):

> To the extent that income taxes are said to be "voluntary," . . . they are only voluntary in that one files the returns and pays the taxes without the IRS first telling each individual the amount due and then forcing payment of that amount. The payment of income taxes is not optional, however, . . . and the average citizen knows that the payment of income taxes is legally required.

See also United States v. Middleton, 246 F.3d 825, 840–41 (6th Cir. 2001); *United States v. Raymond*, 228 F.3d 804, 812–13 (7th Cir. 2000); *United States v. Gerads*, 999 F.2d 1255, 1256 (8th Cir. 1993); *Wilcox v. Commissioner*, 848 F.2d 1007, 1008 (9th Cir. 1988); *United States v. Tedder*, 787 F.2d 540, 542 (10th Cir. 1986); *Moore v. Commissioner*, 722 F.2d 193, 196 (5th Cir. 1984); *Woods v. Commissioner*, 91 T.C. 88, 90 (1988).

Any suggestion that taxpayers may elect not to file returns or pay tax ignores the laws that affirmatively and unambiguously establish these requirements. Specifically, the requirement to pay income taxes is clearly established in section 1 of the Internal Revenue Code, which imposes a tax on the taxable income of individuals, estates, and trusts as determined by the tables set forth in that section, and section 11, which imposes a tax on the taxable income of corporations. The requirement to file an income tax return is explicitly stated in sections 6011(a), 6012(a), and 6072(a) and corresponding Treasury Regulations. In addition, section 6151 requires taxpayers to submit payment of their taxes with their tax returns. Under these provisions of the Code, any taxpayer who has received more than a statutorily determined amount of gross income during the tax year is required to file a return for the year and pay tax on the income.

Underscoring the fallacy of any position that filing a tax return or paying tax is voluntary is the existence of civil and criminal penalties for failing to file or pay. *See Helvering v. Mitchell*, 303 U.S. 391, 399 (1938) ("In assessing income taxes the Government relies primarily upon the disclosure by the taxpayer of the relevant facts . . . [on an] annual return [backed up by] . . . sanctions [that] may . . . be either criminal or civil.") If, as some taxpayers claim, reporting and paying taxes were optional, penalties for noncompliance would not exist and would not be routinely imposed and upheld.

Section 6651(a) imposes an addition to tax for failure to file a required tax return or pay tax unless the failure is due to reasonable cause and not willful neglect. Section 7203 imposes a criminal penalty (in addition to the civil penalty) for willfully failing to file a return or pay tax.

Finally, the Service is not obligated to make returns for taxpayers who fail to do so. Section 6020(b) merely provides the Service with a mechanism for determining the tax liability of a taxpayer who has not filed a return. Section 6020(b) does not require the Service to prepare a tax return in any case, and it does not excuse a taxpayer from the requirements to file and pay or from liability for unpaid taxes, plus civil and criminal penalties for the failure to file or pay.

HOLDING(S)

Taxpayer A must file income tax returns if the income threshold is met and must pay the correct amount of income taxes owed. Compliance with the internal revenue laws, including filing tax returns and paying tax, is not optional. Further, the Service's authority to prepare a return under section 6020(b) does not relieve a taxpayer of the obligation to file a tax return or pay tax. Any claim by Taxpayer A that one may lawfully opt not to file a return or pay tax is frivolous.

The Service will challenge the claims of individuals who improperly attempt to avoid or evade their federal tax liability.

CIVIL AND CRIMINAL PENALTIES

The position described above—that the law permits a taxpayer to choose not to file an income tax return or pay income taxes because these acts are voluntary—is a frivolous position for purposes of section 6702(c). The Service will challenge the claims of individuals who attempt to improperly avoid or evade their federal tax liability. In addition to liability for the tax due plus statutory interest, taxpayers who fail to file valid returns or pay taxes, face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalties, which are generally equal to 20 percent of the amount of tax the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of tax the taxpayer should have paid; (3) the section 6702(a) penalty of $5,000 for filing a document that purports to be a return and that contains a frivolous position or suggests a desire by the taxpayer to delay or impede the administration of federal tax laws; (4) the section 6702(b) penalty of $5,000 for submitting a "specified frivolous submission"; (5) the section 6651 additions to tax for failure to file a return, failure to pay the tax owed, and fraudulent failure to file a return; (6) the section 6673 penalty of up to $25,000 if the taxpayer makes frivolous arguments in the United States Tax Court; and (7) the section 6682 penalty of $500 for providing false information with respect to withholding.

Taxpayers relying on this frivolous position also may face criminal prosecution under: (1) section 7201 for attempting to evade or defeat tax, the penalty for which is a significant fine and imprisonment for up to 5 years; (2) section 7203 for willful failure to file a return, the penalty for which is a significant fine and imprisonment for up to a year; (3) section 7206 for making false statements on a return, statement, or other document, the penalty for which is a significant fine and imprisonment for up to 3 years; and (4) other federal laws as applicable.

Persons, including return preparers, who promote this frivolous position and those who assist taxpayers in claiming tax benefits based on frivolous positions may face civil and criminal penalties and also may be enjoined by a court pursuant to sections 7407 and 7408. Potential penalties include: (1) a $250 penalty under section 6694 for each return or claim for refund prepared by an income tax return preparer who knew or should have known that the taxpayer's position was frivolous

(or $1,000 for each return or claim for refund if the return preparer's actions were willful, intentional, or reckless); (2) a penalty under section 6700 for promoting abusive tax shelters; (3) a $1,000 penalty under section 6701 for aiding and abetting the understatement of tax; (4) criminal prosecution under section 7206, for which the penalty is a significant fine and imprisonment for up to 3 years, for assisting with or advising on the preparation of a false return, statement, or other document under the internal revenue laws; and (5) other federal laws as applicable.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office at (202) 622–7950 (not a toll-free call).

Section 6203.—Method of Assessment

26 CFR 301.6203–1: Method of assessment.
(Also: § 6330.)

Frivolous tax returns; summary record of assessment. This ruling discusses and refutes the frivolous position taken by some taxpayers that before the IRS may collect overdue taxes, the IRS must provide taxpayers with a summary record of assessment made on a Form 23C, *Assessment Certificate-Summary Record of Assessments*, or on another particular form. These taxpayers claim that if a Form 23C is not provided, the assessment is invalid and the IRS may not collect any taxes due.

Rev. Rul. 2007–21

PURPOSE

The Internal Revenue Service (Service) is aware that some taxpayers are claiming that, before the Service may collect overdue taxes, the Service must provide taxpayers with a summary record of assessment made on a Form 23C, "*Assessment Certificate-Summary Record of Assessments*," that is signed by an authorized employee or officer. If a Form 23C is not provided, these taxpayers claim that the assessment is invalid, and, consequently, that the Service may not collect any taxes due.

This revenue ruling emphasizes to taxpayers, promoters, and return preparers that, although an assessment is recorded on a summary record of assessment, such as the Form 23C or its computer-generated equivalent, the Revenue Accounting Control System (RACS) Report 006, there is no legal requirement that a summary record of assessment be provided to a taxpayer before the Service may proceed with collection activity. Further, if a taxpayer requests proof that an assessment was made, the Service is not required to provide any particular form or information in any particular format to the taxpayer so long as the Service provides the information required by Treasury Regulation § 301.6203–1 to the taxpayer. Any position to the contrary has no merit and is frivolous.

The Service is committed to identifying taxpayers who attempt to avoid their federal tax obligations by taking frivolous positions. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through the Service's Frivolous Return Program. As part of this program, the Service determines whether taxpayers who have taken frivolous positions have filed all required tax returns, computes the correct amount of tax and interest due, and determines whether civil or criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters, and others who assist taxpayers in taking frivolous positions, and recommends whether an injunction should be sought to halt these activities. Other information about frivolous tax positions is available on the Service's website at *www.irs.gov*.

ISSUE

Whether the Service must provide a taxpayer with a summary record of assessment, such as a Form 23C, before collection may begin.

FACTS

Taxpayer A argues in a request for a collection due process hearing under section 6330 or 6320 of the Internal Revenue Code that, pursuant to section 6203 and Treasury Regulation § 301.6203–1, the Service must first provide the taxpayer with a summary record of assessment of taxes due before collection action may commence. Taxpayer A further argues that the record provided must include a Form 23C signed by an authorized Service official. In response, the Service provides Taxpayer A with a record of assessment on a Form 4340 ("*Certificate of Assessments, Payments, Other Specified Matters*"), MFTRA-X ("Master File Transcript"), or other similar document. Taxpayer A asserts these forms do not meet the legal requirements and until the Service produces a valid summary record of assessment, the Service is prohibited from collecting the assessed liability. According to Taxpayer A, the Appeals Officer conducting the collection due process hearing, in verifying under section 6330(c)(1) that the Service has complied with applicable law and procedure, may not rely on anything other than the Form 23C to determine, for purposes of the section 6330(c)(1) requirement, that a valid assessment was made.

LAW AND ANALYSIS

Section 6203 states that an assessment of tax (including interest, additions to tax, and assessable penalties) "shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary." The section also states that, when requested by a taxpayer, "the Secretary shall furnish the taxpayer a copy of the record of assessment." Treasury Regulation § 301.6203–1 specifies that an assessment is made "by an assessment officer signing the summary record of assessment," which "*through supporting records*" must include the "identification of the taxpayer, the character of the liability assessed, the taxable period, if applicable, and the amount of the assessment." Under the regulation, if a taxpayer requests a copy of the record of assessment, the Service will give the taxpayer "a copy of the pertinent parts of the assessment which set forth the name of the taxpayer,

the date of assessment, the character of the liability assessed, the taxable period, if applicable, and the amounts assessed." The date of the assessment is the date the summary record is signed.

There is no requirement in the statute or regulation that the assessment be recorded on a specific form or that the taxpayer be provided with a certain form as a record of assessment.

Until its transition to computerized recordkeeping, the Service generally used Form 23C for the summary record of assessment, but it now uses, except in unusual circumstances, a computer-generated summary record of assessment known as the RACS Report 006. Both forms have been recognized as summary records of assessment within the meaning of section 6203. *See March v. Internal Revenue Service*, 335 F.3d 1186, 1188 (10th Cir. 2003). In *Roberts v. Commissioner*, 329 F.3d 1224, 1228 (11th Cir. 2003), the taxpayer argued that an assessment was invalid because the Service did not use Form 23C but instead used RACS Report 006. The court held that there was nothing in the law to show that the use of the RACS report was not in compliance with the statute and the regulation. The RACS report and the Form 23C are both signed by an assessment officer. The RACS report, like the Form 23C, provides, when coupled with "supporting records," the information set forth in Treasury Regulation § 301.6203–1.

In response to a taxpayer's request under section 6203 and the regulation for "a copy of the record of assessment," the Service is not required to provide any particular form or document and may choose among documents that contain the items of information listed in the regulation. Instead of a RACS report 006, which does not break out individual taxpayer information, the Service may provide Form 4340, "*Certificate of Assessments, Payments, Other Specified Matters*," or a MFTRA-X transcript (literal or plain-language transcript) of the taxpayer's account, either of which sets forth all of the information required by the regulation, because each identifies the taxpayer, states the character of the liabilities assessed, the tax period giving rise to the assessment, the amount of the assessment, and the date of assessment. *See Goodman v. United States*, 185 Fed. Appx. 725, 728 (10th Cir. 2006); *Roberts*, 329 F.3d at 1228; *Carillo v. Commissioner*, T.C. Memo. 2005–290; *Michael v. Commissioner*, T.C. Memo. 2003–26. In addition, an Appeals Officer is not required to obtain a Form 23C or other particular document in a collection due process hearing and may rely on a Form 4340 or MFTRA-X transcript to verify the validity of the assessment for purposes of section 6330(c)(1). *See Nestor v. Commissioner*, 118 T.C. 162 (2002); *Perez v. Commissioner*, T.C. Memo. 2002–274.

HOLDING

The Service is not required to provide Taxpayer A with a summary record of assessment before collecting any taxes due. An assessment is not invalid, and collection is not precluded, because the Service has not provided a summary record of assessment to the taxpayer.

Additionally, Taxpayer A's claim that the Service must produce a Form 23C or other record of assessment as proof of assessment is frivolous. If a taxpayer requests a copy of the record of assessment, the Service may produce the information in any form or format, provided the summary produced contains the information required by Treasury Regulation § 301.6203–1. Acceptable copies of the record of assessment include, but are not limited to, Forms 4340 and MFTRA-X transcripts. Further, the Form 4340, MFTRA-X transcript, or other similar documents may be used in a collection due process proceeding to verify the validity of an assessment under section 6330(c)(1).

The Service will challenge the claims of individuals who improperly attempt to avoid or evade their federal tax liability.

CIVIL AND CRIMINAL PENALTIES

The position described above, that the Service must provide a taxpayer with a summary record of assessment, such as a Form 23C, before collection or must provide a Form 23C in any collection proceeding is a frivolous position under section 6702. The Service will challenge the claims of individuals who attempt to improperly avoid or evade their federal tax liability. In addition to liability for the tax due plus statutory interest, taxpayers who insist upon receiving a Form 23C before complying with their tax obligations face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6702(b) $5,000 penalty for submitting a "specified frivolous submission"; (2) the section 6651(a)(3) addition to tax for failure to pay the tax owed; and (3) the section 6673 penalty of up to $25,000 if the taxpayer makes frivolous arguments in the United States Tax Court.

Taxpayers relying on this frivolous position also may face criminal prosecution under section 7201 for attempting to evade or defeat tax, the penalty for which is a significant fine and imprisonment for up to 5 years, or prosecution under other federal laws as applicable.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office at (202) 622–7950 (not a toll-free call).

Section 7701.—Definitions

26 CFR 301.7701–6(a): Person.
(Also: §§ 6012, 7203, 7343, 26 CFR 1.6012–1(a).)

Frivolous tax returns; citizens of a state. This ruling discusses and refutes the frivolous position taken by some taxpayers that they are not subject to federal income tax, or that their income is excluded from taxation, because either (1) they claim to have rejected or renounced United States citizenship and are citizens exclusively of a state (sometimes characterized as a "natural-born citizen" of a "sovereign state"), or (2) they are not persons as identified by the Internal Revenue Code.

Rev. Rul. 2007–22

PURPOSE

The Internal Revenue Service (Service) is aware that some taxpayers are claiming that they are not subject to federal income tax, or that their income is excluded from taxation, because: 1) the taxpayers have declared that they have rejected or renounced United States citizenship

because the taxpayers are citizens exclusively of a State (sometimes characterized as a "natural-born citizen" of a "sovereign state"); or 2) the taxpayers claim they are not persons as identified by the Internal Revenue Code. These taxpayers often furnish Forms W–4, *Employee's Withholding Allowance Certificate*, to their employers on which the taxpayers claim excessive withholding allowances or claim complete exemption from withholding. Based on these Forms W–4, federal income taxes are not withheld from wages paid. Alternatively, these taxpayers attempt to avoid their federal income tax liability by submitting a Form 4852, *Substitute for Form W–2, Wage and Tax Statement, or Form 1099–R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, to the Internal Revenue Service with a zero on the line for the amount of wages received. These taxpayers often either fail to file returns, or file returns showing no income and claiming a refund for any withheld income taxes. The Service is also aware that some promoters, including return preparers, market a book, package, kit, or other materials that claim to show taxpayers how they can avoid paying income taxes based on these and other meritless arguments.

This revenue ruling emphasizes to taxpayers, promoters and return preparers that all U.S. citizens and residents are subject to federal income tax. Any argument that a taxpayer's income is excluded from taxation because: 1) the taxpayer has rejected or renounced United States citizenship because the taxpayer is a citizen exclusively of a State (sometime characterized as a "natural-born citizen" of a "sovereign state"); or 2) the taxpayer is not a person as defined by the Internal Revenue Code and is, therefore, not subject to federal tax, has no merit and is frivolous.

The Service is committed to identifying taxpayers who attempt to avoid their federal tax obligations by taking frivolous positions. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through the Service's Frivolous Return Program. As part of this program, the Service determines whether taxpayers who have taken frivolous positions have filed all required tax returns; computes the correct amount of tax and interest due; and determines whether civil or criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters and others who assist taxpayers in taking frivolous positions, and recommends whether an injunction should be sought to halt these activities. Other information about frivolous tax positions is available on the Service website at *www.irs.gov*.

ISSUES

1. Whether a taxpayer may avoid federal income tax liability by maintaining that the taxpayer is not a citizen of the United States and, thus, is not subject to the federal income tax laws.

2. Whether a taxpayer may avoid federal income tax liability by claiming the taxpayer is not a "person" as defined by the Internal Revenue Code and, thus, is not subject to the federal income tax laws.

FACTS

Taxpayer A claims to be exempt from federal income tax because, as a "sovereign citizen" of Taxpayer A's state of residence, Taxpayer A is not a citizen or resident of the United States and is not subject to federal tax laws.

Taxpayer B claims that the Fourteenth Amendment, providing "[a]ll persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside," applies only to freed slaves and their descendants, and that all other persons are solely citizens of their state of residence.

Taxpayer C claims not to be a United States citizen or a person subject to tax because Taxpayer C has not requested, obtained, or exercised any privilege from an agency of government.

Taxpayer D claims not to be a "person" or a "taxpayer" as defined by the Internal Revenue Code because Taxpayer D is a freeborn and natural individual and not subject to the jurisdiction of the United States.

The taxpayer often furnishes a Form W–4, *Employee's Withholding Allowance Certificate*, to the employer on which the taxpayer claims excessive withholding allowances or claims complete exemption from withholding. Based on this Form W–4, federal income taxes are not withheld from wages paid. Alternatively, the taxpayer prepares a Form 4852 (*Substitute for Form W–2*) showing no wages received.

The taxpayer either fails to file a return, or files a return reporting zero income and claiming a refund for all taxes withheld. The taxpayer then contends the taxpayer is not covered by the federal tax laws and is not subject to federal income tax because the taxpayer is not a citizen of the United States, or the taxpayer is not a person as defined by the Internal Revenue Code.

LAW AND ANALYSIS

1. Citizenship

The Fourteenth Amendment to the United States Constitution defines the basis for United States citizenship, stating that "[a]ll persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside." The Fourteenth Amendment, therefore, establishes simultaneous state and federal citizenship. *See United States v. Cruikshank*, 92 U.S. 542, 549 (1875) ("The same person may be at the same time a citizen of the United States and a citizen of a State. . . ."); *In re Slaughter-House Cases*, 83 U.S. (16 Wall.) 36, 74 (1873) (A man "must reside within the State to make him a citizen of it, but it is only necessary that he should be born or naturalized in the United States to be a citizen of the Union"). The Fourteenth Amendment's granting of citizenship applies to all persons born or naturalized in the United States, regardless of race. *See, e.g., Bell v. State of Maryland*, 378 U.S. 226, 249 (1964) (Douglas, J., concurring) ("The Fourteenth Amendment also makes every person who is born here a citizen; and there is no second or third or fourth class of citizenship.").

Section 7701(a)(9) of the Internal Revenue Code states that "[t]he term 'United States' when used in a geographical sense includes only the States and the District of Columbia." Claims that individuals are not citizens of the United States but are solely citizens of a sovereign state and not

subject to federal taxation have been uniformly rejected by the courts. *See, e.g., United States v. Hilgeford*, 7 F.3d 1340, 1342 (7th Cir. 1993) ("The defendant in this case apparently holds a sincere belief that he is a citizen of the mythical "Indiana State Republic" and for that reason is an alien beyond the jurisdictional reach of federal courts. This belief is, of course, incorrect."); *United States v. Gerads*, 999 F.2d 1255, 1256 (8th Cir. 1993) ("[We] reject appellants' contention that they are not citizens of the United States, but rather "Free Citizens of the Republic of Minnesota" and, consequently, not subject to taxation."); *O'Driscoll v. Internal Revenue Service*, 1991 U.S. Dist. LEXIS 9829, *5–6 (E.D. Penn. 1991) ("Despite plaintiff's linguistic gymnastics, he is a citizen of both the United States and Pennsylvania, and liable for federal taxes.").

Similarly, the individual states are part of the United States and income earned within them is fully subject to United States taxation. *See, e.g., Solomon v. Commissioner*, T.C. Memo. 1993–509 (responding to argument that all of petitioner's income was earned outside of the United States, the court held that "petitioner attempts to argue an absurd proposition, essentially that the State of Illinois is not part of the United States.").

2. Definition of Person

The Internal Revenue Code defines "person" and sets forth which persons are subject to federal taxes. Section 7701(a)(14) defines "taxpayer" as "any person" subject to any internal revenue tax, and section 7701(a)(1) defines "person" to include an individual, trust, estate, partnership, or corporation.

Arguments that an individual is not a "person" within the meaning of the Internal Revenue Code have been uniformly rejected by the courts as have arguments with respect to the term "individual." *See, e.g., United States v. Dawes*, 874 F.2d 746, 750–51 (10th Cir. 1989), *overruled on other grounds*, 895 F.2d 1577 (10th Cir. 1990) ("The contention that appellants are not taxpayers because they are 'free born, white, preamble, sovereign, natural, individual common law '*de jure*' citizens of Kansas' is frivolous. Individuals are 'persons' under the Internal Revenue Code and thus subject to *26 U.S.C. § 7203*."); *United States v. Studley*, 783 F.2d 934, 937 n.3 (9th Cir. 1986) (in holding that an individual is a person under the Internal Revenue Code, the court noted "this argument has been consistently and thoroughly rejected by every branch of the government for decades. Indeed advancement of such utterly meritless arguments is now the basis for serious sanctions imposed on civil litigants who raise them").

Courts have also uniformly rejected claims that a taxpayer is not a person subject to tax because the taxpayer did not request, obtain, or exercise any privileges of citizenship. *See, e.g., Lovell v. United States*, 755 F.2d 517, 519 (7th Cir. 1984) ("All individuals, natural or unnatural, must pay federal income tax on their wages, regardless of whether they received any 'privileges' from the government").

HOLDING

1. The Fourteenth Amendment of the United States Constitution establishes simultaneous state and federal citizenship. Therefore, an individual cannot reject citizenship in the United States in favor of state citizenship, or otherwise claim not to be a citizen of the United States for the purpose of avoiding federal tax liability. Furthermore, income earned within a state of the United States by a United States citizen or resident is taxable under federal tax laws. Accordingly, Taxpayer A and Taxpayer B are subject to federal income tax liability because they are citizens of the United States and citizens of the state in which they reside.

2. The term "person" as used by the Internal Revenue Code includes natural persons and individuals. Moreover, a taxpayer need not request, obtain, or exercise a privilege from an agency of the government to be a "person" within the meaning of the Internal Revenue Code. Therefore, Taxpayer C and Taxpayer D are subject to federal income tax liability.

CIVIL AND CRIMINAL PENALTIES

The Service will challenge the claims of individuals who improperly attempt to avoid or evade their federal tax liability. In addition to liability for the tax due plus statutory interest, taxpayers who fail to file valid returns or pay tax based on arguments that they are not citizens or persons as contemplated by the Internal Revenue Code and, thus, are not subject to federal tax face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalties, which are generally equal to 20 percent of the amount of tax the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of tax the taxpayer should have paid; (3) the section 6702(a) penalty of $5,000 for a "frivolous tax return"; (4) the section 6702(b) penalty of $5,000 for submitting a "specified frivolous submission"; (5) the section 6651 additions to tax for failure to file a return, failure to pay the tax owed, and fraudulent failure to file a return; (6) the section 6673 penalty of up to $25,000 if the taxpayer makes frivolous arguments in the United States Tax Court; and (7) the section 6682 penalty of $500 for providing false information with respect to withholding.

Taxpayers relying on these frivolous positions also may face criminal prosecution under: (1) section 7201 for attempting to evade or defeat tax, the penalty for which is a significant fine and imprisonment for up to 5 years; (2) section 7203 for willful failure to file a return, the penalty for which is a significant fine and imprisonment for up to 1 year; (3) section 7206 for making false statements on a return, statement, or other document, the penalty for which is a significant fine and imprisonment for up to 3 years or (4) other provisions of federal law.

Persons, including return preparers, who promote these frivolous positions and those who assist taxpayers in claiming tax benefits based on frivolous positions may face civil and criminal penalties and also may be enjoined by a court pursuant to sections 7407 and 7408. Potential penalties include: (1) a $250 penalty under section 6694 for each return or claim for refund prepared by an income tax return preparer who knew or should have known that the taxpayer's position was frivolous (or $1,000 for each return or claim for refund if the return preparer's actions were willful, intentional or reckless); (2) a penalty under section 6700 for promoting abusive tax shelters; (3) a $1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (4) criminal prosecution under section 7206, for which

the penalty is a significant fine and imprisonment for up to 3 years, for assisting or advising about the preparation of a false return, statement or other document under the internal revenue laws.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office at (202) 622–7950 (not a toll-free call).

Part III. Administrative, Procedural, and Miscellaneous

Clean Renewable Energy Bonds

Notice 2007–26

SECTION 1. PURPOSE

This notice solicits applications for allocations of the national bond volume limitation authority ("volume cap") to issue tax credit bonds called "clean renewable energy bonds" ("CREBs") under section 54(f) of the Internal Revenue Code (the "Code") to finance eligible clean renewable energy projects described in section 45 of the Code. This notice also provides related guidance on the following: (1) eligibility requirements that a project must meet to be considered for a volume cap allocation; (2) application requirements and the application form for requests for volume cap allocations; (3) the method (generally, a "smallest-to-largest" method) that the Internal Revenue Service ("IRS") and the Treasury Department will use to allocate the volume cap; and (4) certain aspects of the applicable law regarding CREBs and expected regulatory guidance in this area.

Applications for volume cap allocations pursuant to this notice must be filed in accordance with this notice by the following application deadline: July 13, 2007.

This notice *modifies and supersedes* Notice 2005–98, 2005–2 C.B. 1211 (December 11, 2005), which provided guidance on CREBs in connection with the allocation process for the original volume cap authorization under section 54.

SECTION 2. BACKGROUND

Section 1303 of the Energy Tax Incentives Act of 2005, Pub. L. No. 109–58, 119 Stat. 594 (2005), added section 54 to the Code. Section 54 originally provided for a total national volume cap of $800 million for CREBs to finance eligible clean renewable energy projects and delegated to the Secretary of the Treasury the authority to allocate that volume cap, subject to the constraint that the Secretary could allocate no more than $500 million of that volume cap to qualified borrowers which were governmental bodies (with the balance to be allocated to qualified borrowers which were cooperative electric companies). Section 54 originally required that CREBs had to be issued by an expiration date of December 31, 2007.

Section 202 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, 120 Stat. 2922 (2006) (the "2006 Act"), amended section 54 in three respects. First, the 2006 Act increased the total national volume cap for CREBs from $800 million to $1.2 billion. Second, the 2006 Act extended the expiration date for the issuance of CREBs under the total authorized national volume cap of $1.2 billion from December 31, 2007, to December 31, 2008. Third, the 2006 Act increased the maximum allocations or reallocations to qualified borrowers which are governmental bodies from $500 million to $750 million (with the balance to be allocated to cooperative electric companies).

Section 54(a) provides that a taxpayer that holds a CREB on one or more credit allowance dates of the bond occurring during any taxable year is allowed as a nonrefundable credit against Federal income tax for the taxable year an amount equal to the sum of the credits determined under section 54(b) with respect to such dates.

Section 54(b)(1) provides that the amount of the credit with respect to any credit allowance date is 25 percent of the annual credit. Section 54(b)(2) provides that the annual credit is the product of (1) the credit rate determined by the Secretary, multiplied by (2) the outstanding face amount of the bond.

Section 54(b)(3) provides that the Secretary shall determine daily a credit rate that shall apply to the first day on which there is a binding, written contract for the sale or exchange of a CREB. The credit rate for any day is the credit rate the Secretary estimates will permit the issuance of CREBs with a specified maturity or redemption date without discount and without interest cost to the issuer.

Section 54(b)(4) provides that the term "credit allowance date" means March 15, June 15, September 15, December 15, and the last day on which the bond is outstanding. Section 54(b)(5) generally provides that if a bond is issued or redeemed, or matures, during the 3-month period ending on a credit allowance date, then the amount of the credit for that credit allowance date is a ratable portion of the credit otherwise determined for that 3-month period.

Section 54(g) provides that gross income includes the amount of the credit allowed to the taxpayer under section 54 (without regard to section 54(c)) and the amount so included is treated as interest income.

Section 54(d) provides that a "clean renewable energy bond" or CREB means any bond issued as part of an issue if: (1) the bond is issued by a qualified issuer pursuant to an allocation by the Secretary to the issuer of a portion of the volume cap under section 54(f)(2); (2) 95 percent or more of the proceeds of the issue are to be used for capital expenditures incurred by qualified borrowers for one or more qualified projects; (3) the qualified issuer designates the bond for purposes of section 54 and the bond is in registered form; and (4) the issue meets certain requirements described in section 54(h) regarding the expenditure of bond proceeds, including a requirement that the issuer reasonably expects, as of the issue date, that at least 95 percent of the net proceeds will be expended within 5 years.

Section 54(j)(4) defines a "qualified issuer" as: (1) a CREB lender; (2) a cooperative electric company; or (3) a governmental body. Section 54(j)(2) provides that a "CREB lender" is a lender that is: (1) a cooperative that is owned by, or has outstanding loans to, 100 or more cooperative electric companies and was in existence on February 1, 2002; or (2) any affiliated entity controlled by such a lender. Section 54(j)(1) defines the term "cooperative electric company" as a mutual or cooperative electric company described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility that has received a loan or loan guarantee under the Rural Electrification Act. Section 54(j)(3) defines the term "governmental body" as any State, territory, possession of the United States, the District of Columbia, Indian tribal government, or any political subdivision thereof.

Section 54(j)(5) provides that a "qualified borrower" is: (1) a mutual or cooperative electric company described in section

501(c)(12) or 1381(a)(2)(C); or (2) a governmental body.

Section 54(d)(2) defines the term "qualified project" as any of the following qualified facilities (as determined under section 45(d) without regard to any placed in service date) owned by a qualified borrower: (1) a wind facility under section 45(d)(1); (2) a closed-loop biomass facility under section 45(d)(2); (3) an open-loop biomass facility under section 45(d)(3); (4) a geothermal or solar energy facility under section 45(d)(4); (5) a small irrigation power facility under section 45(d)(5); (6) a landfill gas facility under section 45(d)(6); (7) a trash combustion facility under section 45(d)(7); (8) a refined coal production facility under section 45(d)(8); and (9) a qualified hydropower facility under section 45(d)(9).

Section 54(f)(1), as amended by section 202(a)(1) of the 2006 Act, provides that the national volume cap is $1.2 billion. Section 54(f)(2), as amended by section 202(a)(2) of the 2006 Act, provides that the Secretary shall allocate the volume cap among qualified projects in such manner as the Secretary determines appropriate, except that the Secretary may not allocate more than $750 million of the national volume cap to finance qualified projects of qualified borrowers that are governmental bodies. The amendments to section 54 of the Code made by section 202 of the 2006 Act apply to bonds issued, and allocations or reallocations of volume cap made, after December 31, 2006.

Section 54(d)(2)(D) provides that, for purposes of section 54(d)(1)(B), which requires qualified borrowers to use at least 95 percent of the proceeds of an issue for capital expenditures for qualified projects, any action that a qualified borrower or qualified issuer takes that is within its control and that causes such proceeds to fail to be used for a qualified project is treated as failing to satisfy that requirement. Section 54(d)(2)(D) further provides that the Secretary shall prescribe regulations specifying remedial actions that may be taken (including conditions to taking such remedial actions) to prevent an action described in the preceding sentence from causing a bond to fail to be a CREB.

Section 54(k) generally requires that, for a CREB that is a pooled financing bond under section 149(f)(4)(A), borrowers must enter into written loan commitments before the issue date of the CREB.

Section 54(l)(5) requires that the qualified issuer pay and amortize an equal amount of the principal of an issue of CREBs during each calendar year that the issue is outstanding.

Section 54(e)(1) limits the term of a CREB to the maximum term determined by the Secretary under section 54(e)(2). Section 54(e)(2) provides that, during each calendar month, the Secretary shall determine the maximum term for CREBs issued in the following calendar month. The maximum term is the term the Secretary estimates will result in the present value of the obligation to repay the principal on the bond being equal to 50 percent of the face amount of the bond. Section 54(e)(2) further provides that such present value shall be determined (1) without regard to the requirement of section 54(l)(5) to amortize the principal of CREBs amortized ratably each year and (2) using a discount rate equal to the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month. If the term as so determined is not a multiple of a whole year, such term shall be rounded to the next highest whole year.

Section 54(i) generally provides that the arbitrage requirements of section 148 applicable to tax-exempt State or local bonds apply to CREBs.

Section 54(l)(6) requires issuers of CREBs to submit information reporting returns to the IRS similar to those required to be submitted under section 149(e) for tax-exempt State or local governmental bonds.

Notice 2006–7, 2006–10 I.R.B. 559 (March 6, 2006), provides guidance regarding certain definitions used for CREB purposes.

SECTION 3. APPLICATION REQUIREMENTS IN GENERAL

Each application for a CREBs volume cap allocation ("Application") must be prepared and submitted in accordance with this section. In order for an Application to comply with this section, among other things, the Application must be prepared in substantially the form attached to this notice as Appendix A, subject to such minor changes or variations as the IRS and the Treasury Department may approve in their discretion. This notice, including Appendix A, may be found on the IRS web site at *http://www.irs.gov/taxexemptbond/index.html* or *http://www.irs.gov/pub/irs-drop/*. By submitting an Application, the applicant agrees to comply with the requirements of this notice.

a. *Qualified issuer*. An Application must be submitted by a qualified issuer within the meaning of section 54(j)(4). A "qualified issuer" is: (1) a CREB lender (as defined in section 54(j)(2)); (2) a cooperative electric company (as defined in section 54(j)(1)); or (3) a governmental body (as defined in section 54(j)(3)). An Application must identify the qualified issuer and must demonstrate that the entity constitutes a qualified issuer within the meaning of section 54(j)(4).

b. *Signatures*. An Application must be signed and dated by, and must include the printed name and title of, an authorized official of the qualified issuer. For purposes of this notice, the term "authorized official of the qualified issuer" means an officer, board member, employee, or other official of the qualified issuer who is duly authorized to execute legal documents on behalf of the qualified issuer in connection with incurring debt of the qualified issuer (*e.g.*, a mayor, chairperson of a city council, chairperson of a board of directors, county or city administrator or manager, or chief financial officer), similar to the kind of duly authorized official of an issuer who would be authorized to execute documents in connection with an issuer's declaration of official intent to reimburse expenditures from the proceeds of a borrowing under § 1.150–2(e).

c. *Contact person*. An Application must designate one or more persons with knowledge regarding the project, whom the qualified issuer duly authorized to discuss with the IRS any information relating to the Application. The designation must include the designee's name, title, telephone number, fax number, and mailing address. If a designee is not an official or officer of the issuer, the Application must include an executed Form 8821 (*Tax Information Authorization*), authorizing the disclosure of taxpayer information specifically relating to the Application to the designee.

d. *Addresses*. An Application must be submitted in one of the following ways: (1) by hard copy in duplicate accompa-

nied by a copy of the application in electronic format on compact disc ("CD") by mail to the Internal Revenue Service (IRS), Attention SE:T:GE:TEB, 1111 Constitution Avenue, NW, PE – 5N3, Washington, D.C. 20224; (2) by hard copy in duplicate accompanied by a copy of the application in electronic format on compact disc ("CD") by hand delivery Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, PE – 5N3, Washington, D.C., attention SE:T:GE:TEB; or (3) by electronic submission in PDF format of a copy of a signed original document to the IRS to *Tina.F.Hill@irs.gov*.

e. *Due date*. An Application must be filed with the IRS on or before the Application deadline of July 13, 2007.

f. *Project description*. Each Application must contain the information required by this subsection f.

(i) *Qualified borrower*. Each Application must identify the qualified borrower expected to own the qualified project. A "qualified borrower" is: (1) a mutual or cooperative electric company described in sections 501(c)(12) or 1381(a)(2)(C); or (2) a governmental body (as defined in section 54(j)(3)). The Application must demonstrate that the entity is a qualified borrower within the meaning of section 54(j)(5). If any bond is expected to be a pooled financing bond (within the meaning of section 149(f)(4)(A)), the Application must demonstrate that the qualified issuer will enter into a written loan commitment with each qualified borrower prior to the issue date of the issue of CREBs.

(ii) *Qualified project*. Each Application must describe in reasonable detail the project or projects to be financed with the proceeds of the CREBs. The Application must demonstrate that each project will constitute a "qualified project" under section 54(d)(2)(A). The Application must indicate the expected date that the acquisition and construction of each project will commence and the expected date that each project will be placed in service. The Application must contain a certification by an independent, licensed engineer that each project will meet the requirements for a qualified facility under section 45(d) (but without regard to section 45(d)(10) and to any placed in service date) and that the project will be technically viable and will produce electricity. If the project is a qualified hydropower facility under section 45(d)(9) producing incremental hydropower production (as defined under section 45(c)(8)(B)), then the certification also must state that the project consists only of efficiency improvements or additions to capacity that produce additional production as described in section 45(c)(8)(B) based on a methodology that would meet Federal Energy Regulatory Commission (FERC) standards. If the project is a qualified hydropower facility under section 45(d)(9) producing qualified hydropower production that is a nonhydroelectric dam under section 45(c)(8)(C), then the certification also must state that the facility, when constructed, will meet FERC licensing requirements and other applicable environmental, licensing and regulatory requirements.

(iii) *Prior allocations and related projects*. Each Application must describe the amount of CREB volume cap previously allocated to each project described in the Application and to any "related projects." For purposes of this notice and the Application, the term "related projects" means projects that are owned by the same qualified borrower, or a "related party" as defined in § 1.150–1(b), located on the same site, and integrated, interconnected, or directly or indirectly dependent on each other, based on all the facts and circumstances ("Related Projects").

(iv) *Location of project*. The Application must indicate the location of the project.

(v) *Regulatory approvals*. The Application must describe a plan to obtain all necessary Federal, state and local regulatory approvals for the project.

g. *Plan of financing*. The Application must contain a reasonably detailed description of the plan of financing for the project, including all reasonably expected sources and uses of financing and other funds, the status of such financing, the anticipated date of bond issuance, the sources of security and repayment for the bonds, the aggregate face amount of bonds expected to be issued for the project, and the issuer's reasonably expected schedule for spending proceeds of CREBs. If the qualified borrower intends to use the proceeds of CREBs, to refinance qualified projects with CREBs, or to reimburse amounts paid with respect to a qualified project, the Application must demonstrate that the requirements under section 54(d)(2)(B) and (C), respectively, will be met.

h. *Dollar amount of allocation requested*. The Application must specify the dollar amount of the volume cap requested.

SECTION 4. REQUIRED DECLARATIONS IN APPLICATIONS

Each Application submitted under this notice must include the following declaration signed and dated by an authorized official of the qualified issuer who has personal knowledge of the relevant facts and circumstances: "Under penalties of perjury, I declare that I have examined this document and, to the best of my knowledge and belief, all of the facts contained herein are true, correct, and complete."

SECTION 5. CONSENT TO DISCLOSURE OF ALLOCATION

In order to provide the public with information on how the volume cap authorized by Congress has been allocated and facilitate oversight of the CREB program, the IRS intends to publish the results of the allocation process. The information will be the most useful to the public if it identifies the specific allocations awarded. Pursuant to § 6103, consent is required in order for the Service to disclose identifying information with respect to applicants awarded an allocation. Therefore, the Service requests that each applicant submit with the Application a declaration, consenting to the disclosure by the Internal Revenue Service of the name of the applicant (issuer), the name of the borrower (if other than the issuer), the type and location of the project that is the subject of the Application, and the amount of the CREBs volume cap allocation for such project in the event the project receives an allocation. To provide valid consent, the declaration must be in the form set forth in Appendix B. An applicant is not required to provide a declaration consenting to disclosure in order to receive an allocation. The Service will not publish identifying information with respect to applications that are not awarded an allocation of volume cap.

SECTION 6. VOLUME CAP ALLOCATIONS AND METHODOLOGY

a. *In general.* Available CREB volume cap under section 54, as amended by the 2006 Act, and any "relinquished volume cap" (as defined in paragraph b. of this section) will be allocated in accordance with this section to qualified projects for which Applications meeting the requirements of this notice have been filed with the IRS on or before the Application deadline set forth in this notice. Projects for governmental bodies and mutual or cooperative electric companies described in sections 501(c)(12) or 1381(a)(2)(C) will be allocated the full amount of volume cap requested beginning with the project(s) for which the smallest dollar amount of volume cap has been requested and continuing with the project(s) for which the next-smallest dollar amount of volume cap has been requested until the total amount of volume cap has been exhausted. For this purpose, any amount of the volume cap previously allocated to a project will be taken into account by increasing the amount requested for the project in the Application submitted pursuant to this notice by the amount previously allocated to the project. All applications that meet the requirements described in this notice will be granted according to the methodology set forth above until all applications from governmental bodies have been granted, or up to a maximum of $750 million has been allocated to projects of qualified borrowers that are governmental bodies, whichever occurs first. The remaining volume cap will be allocated under the smallest-to-largest methodology described above to qualified projects of qualified borrowers that are not governmental bodies. For purposes of this section, all Related Projects will be treated as a single project.

b. *Relinquished volume cap.* For purposes of this notice, "relinquished volume cap" means volume cap previously allocated to a qualified issuer to finance a qualified project for which the IRS has received written notice from a duly authorized official of the qualified issuer before the due date for Applications under this notice which states that the qualified issuer will not issue CREBs pursuant to the allocation and is relinquishing such allocation.

SECTION 7. EXPECTED TEMPORARY REGULATIONS; EFFECTIVE DATES; RELIANCE ON NOTICE

The Treasury Department and the IRS expect to issue temporary and proposed regulations (the "Temporary Regulations") under section 54 to provide guidance to holders and issuers of CREBs on selected issues regarding the CREBs program, including potentially, among other matters, certain definitions, general CREBs program requirements, qualified projects, use and expenditure of proceeds, remedial actions, arbitrage investment restrictions, and information reporting applicable to CREBs. The Treasury Department and the IRS expect that the Temporary Regulations will apply to CREBs sold on or after June 13, 2007 with respect to interim guidance provided in this notice. Prior to the promulgation and effective date of the Temporary Regulations on CREBs under section 54, taxpayers may rely on the interim guidance provided in this notice and Notice 2006–7.

SECTION 8. MAXIMUM TERM

The maximum term for a CREB is determined under section 54(e)(2) by using a discount rate equal to 110 percent of the long-term adjusted AFR, compounded semi-annually, for the month in which the bond is sold. For purposes of this notice, a bond is "sold" on the first day on which there is a binding contract in writing for the sale or exchange of the bond. The maximum term for a CREB will be published daily by the Bureau of Public Debt on its Internet site for State and Local Government Series securities at: *https://www.treasurydirect.gov*.

SECTION 9. CREDIT RATE

For each issue of CREBs, a separate credit rate will apply to each of the level annual repayments of principal of the issue (each, a "principal maturity"). The credit rate for a principal maturity of an issue of CREBs is the applicable CREB credit rate for that principal maturity on the date that the issue of CREBs is sold, which applicable CREB credit rate is published for that day by the Bureau of Public Debt on its Internet site for State and Local Government Series securities at: *https://www.treasurydirect.gov*. The credit rates will be determined by the Treasury Department based on its estimate of the yield on outstanding AA rated corporate bonds of a similar maturity for the business day immediately prior to the date on which the issue is sold.

SECTION 10. INFORMATION REPORTING

Section 54(l)(6) requires issuers of CREBs to submit information reporting returns to the IRS similar to those required to be submitted under section 149(e) for tax-exempt State or local governmental bonds. These information reporting returns are required to be submitted at the same time and in the same manner as those under section 149(e) on such forms as shall be prescribed by the Commissioner of the IRS for such purpose. Pending further guidance from the IRS regarding the applicable forms to be used for such information reporting for CREBs, in the case of an issue of CREBs, the issuer must submit to the IRS an information return on Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues*, at the same time and in the same manner as required under section 149(e), with modifications as described below. Issuers of CREBs should complete Part II of Form 8038 by checking the box on Line 20(c) (Other) and writing "CREBs" in the space provided for the bond description. For purposes of this notice, the term "issue" has the meaning used for tax-exempt bond purposes in § 1.150–1(c).

SECTION 11. REMEDIAL ACTIONS

The Treasury Department and the IRS expect that the Temporary Regulations will provide that, for purposes of the requirement of section 54(d)(1)(B) that qualified borrowers use at least 95 percent of the proceeds of an issue of CREBs for capital expenditures for qualified projects, a "deliberate action" taken by a qualified issuer or qualified borrower may cause such proceeds to fail to be used for such qualified use. For this purpose, the term "deliberate action" will have the same meaning as used in § 1.141–2(d)(3), except that "section 54" will be substituted for "section 141" in § 1.141–2(d)(3)(i). The Treasury Department and the IRS further expect that the Temporary Regulations will

provide that a deliberate action that otherwise would cause an issue of CREBs to fail to meet the requirements of section 54(d)(1)(B) will not be treated as a deliberate action if the issuer takes a "remedial action" which meets the requirements specified in the Temporary Regulations. In addition, the Treasury Department and the IRS expect that the Temporary Regulations will contain a "redemption or defeasance" remedial action and an "alternative use of disposition proceeds" remedial action similar, but not identical to, the remedial actions contained in § 1.141–12(d) and § 1.141–12(e).

SECTION 12. ARBITRAGE REQUIREMENTS

Section 54(i) generally requires that an issue of CREBs must satisfy the arbitrage investment restrictions under section 148 applicable to tax-exempt bonds with respect to proceeds of the issue. In general, under section 148, subject to various specific prompt spending exceptions and other exceptions, the arbitrage investment restrictions, including the yield restrictions and the arbitrage rebate requirement, apply broadly to gross proceeds of tax-exempt bonds. The Treasury Department and the IRS expect that, except as otherwise provided in this section 12, the arbitrage investment restrictions under section 148 and § 1.148–1 to § 1.148–11, inclusive, and the exceptions to those restrictions will apply to gross proceeds of CREBs to the same extent and in the same manner as they apply to gross proceeds of tax-exempt state or local governmental bonds the interest on which is excludable from gross income under section 103.

The Treasury Department and the IRS further expect that, in applying the arbitrage investment restrictions under section 148 to CREBs, the modifications to the general rules described in paragraphs a. through e. of this section 12, below, will apply.

a. *Cooperative electric companies treated like state or local governmental entities*. Cooperative electric companies under section 54(j)(1) will be treated as "governmental persons" under § 1.141–1(b) for purposes of (1) applying the arbitrage investment restrictions under section 148, including the program investment definition under § 1.148–1(b), and (2) determining whether CREBs are private activity bonds under section 141 in applying any particular arbitrage investment restriction that depends on whether bonds are private activity bonds,

b. *5-year temporary period exception to arbitrage yield restriction*. If an issue of CREBs meets the spending requirements of section 54(h)(1), then the proceeds of the issue of CREBs will be treated as qualifying for a 5-year temporary period exception to arbitrage yield restriction under § 1.148–2(e)(2) beginning on issue date of the issue.

c. *CREB credit disregarded in determining CREB yield for arbitrage purposes*. In determining the yield on an issue of CREBs for arbitrage purposes under § 1.148–4, the CREBs credit allowed under section 54(a) and the credit rate under section 54(b)(2)(A) will be disregarded.

d. *Non-AMT tax-exempt bond investment exception inapplicable*. In applying the arbitrage restrictions against investing gross proceeds of an issue of CREBs in higher yielding investments under section 148(a) and § 1.148–2, the exception to arbitrage yield restriction for investments of gross proceeds of tax-exempt bonds in specified non-AMT tax-exempt bond investments under section 148(b)(3) (relating to an exception to the definition of "investment property" for specified non-AMT tax-exempt bonds) and § 1.148–2(d)(2)(v) (relating to a corresponding exception to arbitrage yield limitations) will be inapplicable.

e. *Application of small issuer exception to the arbitrage rebate requirement*. In determining whether an issue of CREBs qualifies for the $5 million small issuer exception to the arbitrage rebate requirement (increased to $10 million for certain public school facilities) under section 148(f)(4)(D) and § 1.148–8, both CREBs and tax-exempt bonds the interest on which is excludable from gross income under section 103 (other than private activity bonds) that are reasonably expected to be issued or actually issued by the CREB issuer (and other applicable on-behalf-of entities and subordinate entities taken into account under that section) within a calendar year will be taken into account in measuring the applicable size limitation.

SECTION 13. MISCELLANEOUS REGULATORY GUIDANCE

The Treasury Department and the IRS expect that the Temporary Regulations will provide guidance on selected discrete issues that have arisen with respect to CREBs, including clarifying that: (1) in applying the reimbursement restrictions under section 54(d)(1)(C), the general reimbursement rules and exceptions in § 1.150–2 will apply; (2) joint ownership of projects financed with CREBs will be recognized in a manner similar to the recognition of joint ownership of output projects under the private activity bond restrictions on tax-exempt bonds under section 141; (3) in determining whether all or a part of a facility will be eligible to be a qualified project for CREBs purposes, allocation and accounting rules similar to those employed under section 141 for mixed-use projects will be applied; (4) for purposes of the requirement under section 54(d) to use 95 percent of the proceeds of an issue of CREBs for qualified costs to finance capital expenditures for qualified projects, proceeds used to finance a reserve or replacement fund (*e.g.*, a debt service reserve fund to secure the CREBs) will be treated as nonqualified costs and will be eligible for financing with CREBs only from the five percent nonqualified portion of the proceeds; and (5) except in limited circumstances involving certain refinancings to which section 54(d)(2)(B) applies and reimbursements to which section 54(d)(2)(C) applies, costs of acquiring existing facilities (as contrasted with costs of enhancements, repair, or rehabilitation of existing facilities) generally will be treated as nonqualified costs for purposes of the 95 percent use of proceeds test under section 54(d).

SECTION 14. EFFECT ON OTHER DOCUMENTS

This notice *modifies* and *supersedes* Notice 2005–98, 2005–2 C.B. 1211 (December 11, 2005), which provided guidance on CREBs in connection with the allocation process for the original volume cap authorization under section 54.

SECTION 15. DRAFTING INFORMATION

The principal authors of this notice are Zoran Stojanovic and Timothy Jones of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice and the Application, contact Tina Hill at (202) 283–9774 (not a toll-free call).

APPENDIX A

APPLICATION FOR ALLOCATION OF CLEAN ENERGY RENEWABLE BOND VOLUME CAP

Internal Revenue Service

Washington, D.C.

Dear Sir or Madam:

The following constitutes the application ("Application") of (Name) (the "Applicant") for allocation of clean renewable energy bond ("CREB") volume cap under Section 54(f) of the Internal Revenue Code (the "Code") (unless otherwise noted, section references herein are to the Code) to finance the project described below. *(If a single Application is used to request CREB volume cap for more than one project, then all of the required information in the Application must be provided separately for each project.)*

1. **Name of Applicant/Issuer** ____________________

   Street Address ____________________

   City ____________ State ____________ Zip ____________

   Telephone Number ____________ Fax Number ____________

2. **Status of Issuer** – *(Select as appropriate)*

   The Applicant/Issuer is a "qualified issuer " under section 54(j)(4) because it is—

   (i) a "clean renewable energy lender" that is a cooperative owned by, or has outstanding loans to, 100 or more cooperative electrical companies and was in existence on February 1, 2002 or is an affiliate that is owned by such a lender, as demonstrated by the attached documents included as Exhibit D.

   (ii) a "cooperative electric company" that is a mutual or cooperative electric company described in section 501(c)(12) or section 1381(a)(2)(C), as demonstrated by the attached documents included as Exhibit D, including a copy of the determination letter previously obtained from the IRS, if any (or other relevant documents).

   (iii) a "governmental body" that is a State, territory, possession of the United States, District of Columbia, Indian tribal government, or any political subdivision of the foregoing, as demonstrated by the attached documents included as Exhibit D. *(Supporting documents are not required to be attached for governmental bodies that are general purpose governmental entities with substantial taxing, eminent domain,* ***and*** *police powers such as generally a county, city, municipality, township, or borough.)*

3. **Name of Borrower** ____________________

   Street Address ____________________

   City ____________ State ____________ Zip ____________

   Telephone Number ____________ Fax Number ____________

4. **Status of Borrower** – *(Select as appropriate)* The Borrower is a "qualified borrower" under section 54(j)(5) because it is—

   (i) a qualified borrower under section 54(j)(5)(A) that is a mutual or cooperative electric company under section 501(c)(12) or section 1381(a)(2)(C), as demonstrated by the attached documents included as Exhibit D, including a copy of the determination letter previously obtained from the IRS, if any (or other relevant documents).

(ii) a qualified borrower under section 54(j)(5)(B) that is a "governmental body" under section 54(j)(3)(B) and is a State, territory, possession of the United States, District of Columbia, Indian tribal government, or any political subdivision of the foregoing, as demonstrated by the attached documents included as Exhibit D. *(Supporting documents are not required to be attached for governmental bodies that are general purpose governmental entities with substantial taxing, eminent domain,* ***and*** *police powers such as generally a county, city, municipality, township, or borough.)*

5. **Name of Project.**

____

____

6. **Detailed Description of Project.** A reasonably detailed description of the project (the "Project") is set forth below or in attached Exhibit A, including reasonably expected costs of components, such as land, site prep, equipment, installation, other dedicated facilities such as transmission, and capacity:

7. **Qualified Project.** The Project is a "qualified project" within the meaning of section 54(d)(2)(A) of the Code, because it is a "qualified facility" (as determined under section 45(d) of the Code without regard to section 45(d)(10) and to any placed in service date) that is *(select as appropriate)*—

   (1) a wind facility – a facility using wind to produce electricity;

   (2) a closed-loop biomass facility – a facility using closed-loop biomass (as defined in section 45(c)) to produce electricity or, if owned by the taxpayer prior to January 1, 2008, a facility using closed-loop biomass to produce electricity which is modified to use closed-loop biomass to co-fire with coal, with other biomass, or with both, but only if the modification is approved under the Biomass Power for Rural Development Programs or is part of a pilot project of the Commodity Credit Corporation;

   (3) an open-loop biomass facility – a facility using open-loop biomass (as defined in section 45(c)) to produce electricity and in the case of a facility using agricultural livestock waste nutrients, the nameplate capacity rating of which is not less than 150 kilowatts;

   (4) a geothermal or solar energy facility – a facility using geothermal energy (as defined in section 45(c)) or solar energy to produce electricity (not including a facility described in section 48(a)(3) the basis of which is taken into account by the taxpayer for purposes of determining the energy credit under section 48 of the Code);

   (5) a small irrigation power facility – a facility using small irrigation power (as defined in section 45(c)) to produce electricity;

   (6) a landfill gas facility – a facility producing electricity from gas derived from the biodegradation of municipal solid waste (as defined in section 45(c));

   (7) a trash combustion facility – a facility that burns municipal solid waste (as defined in section 45(c)) to produce electricity;

   (8) a refined coal production facility – a facility producing refined coal (as defined in section 45(c)); or

   (9) a qualified hydropower facility – a facility engaged in qualified hydropower production (as defined in section 45).

8. **Construction Commencement Date and Placed in Service Date.** The Borrower begun or expects to begin the construction, installation and equipping of the Project on ____________________. The Borrower expects that the Project will be placed into service on or before ____________________.

9. **Independent Engineer's Certificate:** *(If the Application is for more than one Project, a separate certificate must be included for each Project.)* Attached as Exhibit B hereto is a certification by an independent, licensed engineer to the effect that the Project will be a "qualified project" within the meaning of section 54(d)(2)(A) and a "qualified facility" within the meaning of section 45(d) of the Code (without regard to section 45(d)(10) of the Code and to any placed in service date) and that the project is technically viable and will produce electricity.

   If the project is a **qualified hydropower facility —**

   a. producing incremental hydropower production, then the engineering certificate also must state that the project consists only of efficiency improvements or additions to capacity that produce additional production as described in section 45(c)(8)(B) based on a methodology that would meet Federal Energy Regulatory Commission (FERC) standards; or

b. that is a nonhydroelectric dam under section 45(c)(8)(C), then the engineering certificate also must state that the facility, when constructed, will meet FERC licensing requirements and other applicable environmental, licensing and regulatory requirements.

10. **Location of the Project:**

Project address or physical location (do not include postal box numbers or mailing address)

____

____

____

City ________________ State ________________ Zip __________

County where Project is located ________________________________

11. **Individual to contact** for more information about the Project:

Individual Name ____

Company Name ____

Street Address ____

City ________________ State ________________ Zip __________

Telephone Number ____

Fax Number ____

(Include as appropriate) The contact person is not an authorized official or officer of the Issuer and a properly executed Form 8821 is included with this Application that authorizes the disclosure by the IRS of information that relates to this Application and the Project(s) described above to the contact person.

12. **Regulatory Approvals.** Identify each regulatory body, the action that must be taken, status of any pending action and the remaining timeframe required to obtain each required approval such as a FERC approval, or siting permits. The plan of the Applicant for obtaining such approvals is as follows: *(or attach an Exhibit)*

13. **Plan of Financing.** Include a reasonably detailed description of the plan of financing for the Project, including all reasonably expected sources and uses of financing and other funds, the status of such financing, the anticipated date of bond issuance, the sources of security and repayment for the bonds, the aggregate face amount of bonds expected to be issued for the Project, and the issuer's reasonably expected schedule for spending proceeds of CREBs. Attached as Exhibit C is a plan of financing for the Project.

14. **Refinancings and Reimbursements.** *(Include the following statements, as applicable.)* [*(For refinancings, include the following statement.)* The Issuer intends to use the proceeds of CREBs to refinance qualified projects in accordance with section 54(d)(2)(B).] [*(For reimbursements, include the following statement.)* The Issuer intends to use the proceeds of CREBs to reimburse costs of a qualified project in accordance with section 54(d)(2)(C).] *(In addition, the Issuer must demonstrate that the requirements of § 54(d)(2)(B) or (C), as applicable, will be met.)*

15. **Dollar Amount of Allocation Requested for the Project.** To finance the Project, the Applicant hereby requests a CREB allocation in the amount of $________.

16. **Prior Allocations for the Project or Related Project.** *(If the Project or any Related Project (as defined in section 3.f(iii) of this Notice) previously received an allocation of CREBs volume cap, then this paragraph must include a statement to that effect.)*

[*If applicable, include the following statement:* On *(Insert date)*, the Project previously received a CREBs volume cap allocation in the amount of $________. A copy of the IRS allocation letter for that allocation is attached.]

[*If applicable, include the following statement:* On *(Insert date)*, a Related Project previously received a CREBs volume cap allocation in the amount of $________. A copy of the IRS allocation letter for that allocation is attached.]

17. **Other allocation requests for Related Projects to the Project.** Included below are descriptions of other projects that are Related Projects (as defined in paragraph 16 above) to the Project for which the applicant or other entities are applying for a CREB volume cap allocation. With respect to an applicant on a Related Project other than the Applicant, set forth below are the names, addresses, contact persons, and telephone numbers for any such applicant.

18. Pooled Financing Bonds. *(If the issuer expects to use the requested allocation of CREB volume cap as part of a pooled financing bond within the meaning of section 54(l)(2), then the issuer should include the undertaking noted below.)*

[The Applicant Issuer expects to use the requested allocation for CREBs volume cap in a pooled financing bond within the meaning of section 54(i)(2), and the Issuer expressly agrees that it will obtain a written loan commitment for all borrowers from the issue of CREBs to which the requested allocation relates before the issue date of that issue.]

I hereby certify that I am an authorized officer or official of the Applicant and am duly authorized to execute legal documents on behalf of the Applicant in connection with incurring debt and that I am duly authorized to execute legal documents on behalf of the Application in making this Application. Under penalties of perjury, I declare that (i) I have knowledge of the relevant facts and circumstances relating to this Application and the Project(s), (ii) I have examined this Application, and (iii) to the best of my knowledge and belief, all of the facts contained in this Application are true, correct and complete.

By: ______________________________

Name and Title: ______________________________

Date: ______________________________

EXHIBIT A

DESCRIPTION OF THE PROJECT (RESPONSE TO QUESTION 6 OF THE APPLICATION)

(Attached hereto)

EXHIBIT B

ENGINEER'S CERTIFICATE (RESPONSE TO QUESTION 9 OF THE APPLICATION)

(Attached hereto in substantially the form below)

Dated: ______________, 2007

This certificate is being provided to the Internal Revenue Service ("IRS") in connection with an application (the "Application") by [*Name of Applicant Issuer*: ______________________________] (the "Issuer") to the IRS requesting an allocation of volume cap authority to issue clean renewable energy bonds ("CREBs") under section 54 of the Internal Revenue Code, as amended (the "Code"). The CREBs are being issued to make a loan to [*Name of qualified borrower*: ______________ (the "Borrower"), to finance the costs of certain clean renewable energy facilities described more particularly in the Application (the "Project"). The undersigned hereby certifies as follows:

1. I am an independent, licensed engineer, duly qualified to practice the profession of engineering under the laws of the State of ______________, and I am not an officer or employee of the Issuer or the Borrower.

2. I have reviewed the Application for a CREBs volume cap allocation (including the exhibits thereto) of the Issuer of even date herewith describing the Project. To the best of my knowledge, information, and belief, the Project will meet the requirements to be a "qualified project" under section 54(d)(2)(A) of the Code and correspondingly a "qualified facility" under section 45(d) of the Code, determined without regard to section 45(d)(10) of the Code and without regard to any placed in service date).

[*(Include as appropriate)* To the best of my knowledge, information, and belief, the Project is a qualified hydropower facility under section 45(d)(9)—

a. producing incremental hydropower production consisting only of efficiency improvements or additions to capacity that produce additional production as described in section 45(c)(8)(B) based on a methodology that would meet Federal Energy Regulatory Commission (FERC) standards. or

b. that is a nonhydroelectric dam under section 45(c)(8)(C) and the facility, when constructed, will meet FERC licensing requirements and other applicable environmental, licensing and regulatory requirements.]

3. To the best of my knowledge, information and belief, the Project is technically viable and when constructed will produce electricity.

IN WITNESS WHEREOF, I have hereunto affixed my official signature on the date of this Engineer's Certificate.

By: ______________________________

Seal and/or License number:

Name and Title: ______________________________

____

Company: ______________________________

EXHIBIT C

PLAN OF FINANCING
(RESPONSE TO QUESTION 13 OF THE APPLICATION)

(Attached hereto)

EXHIBIT D

DOCUMENTS REGARDING ISSUER OR BORROWER ORGANIZATIONAL STATUS
(RESPONSE TO QUESTION 2 OR 4 OF THE APPLICATION, AS APPLICABLE)

(Attached hereto)

APPENDIX B

CONSENT TO PUBLIC DISCLOSURE
OF CERTAIN CLEAN RENEWABLE ENERGY BOND
APPLICATION INFORMATION

In the event that the Application of [*(Insert name of applicant here)*: ______________________] (the "Applicant") for an allocation of authority to issue clean renewable energy bonds ("CREBs") under section 54 of the Internal Revenue Code is approved, the undersigned authorized representative of the Applicant hereby consents to the disclosure by the Internal Revenue Service through publication of a Notice in the Internal Revenue Bulletin or a press release of the name of applicant (issuer), the name of the borrower (if other than the issuer), the type and location of the project that is the subject of the Application, and the amount of the allocation, if any, of volume cap authority to issue CREBs for such project. The undersigned understands that this information might be published, broadcast, discussed or otherwise disseminated in the public record.

This authorization shall become effective upon the execution thereof. Except to the extent disclosure is authorized herein, the returns and return information of the undersigned taxpayer are confidential and are protected by law under the Internal Revenue Code.

I certify that I have the authority to execute this consent to disclose on behalf of the taxpayer named below.

Date: ______________________ Signature: ______________________

Print name: ______________________

Title: ______________________

Name of Applicant-Taxpayer: ______________________

Taxpayer Identification Number: ______________________

Taxpayer's Address: ______________________

____

____

Note: Treasury Regulations require that the Internal Revenue Service must receive this consent within 60 days after it is signed and dated.

Certain Deduction Limits Under the Pension Protection Act of 2006

Notice 2007–28

This notice provides guidance on certain of the changes made by the Pension Protection Act of 2006, Pub. L. 109–280 (PPA '06), to § 404 of the Internal Revenue Code (Code). Section 404 generally provides rules concerning the deduction for contributions to plans of deferred compensation. Some of the PPA '06 amendments to § 404 are effective for years beginning after December 31, 2005 (the 2006 changes) and others are effective for years beginning after December 31, 2007 (the 2008 changes). This notice provides guidance with respect to the 2006 changes and one related issue. Future guidance will be provided with respect to the 2008 changes.

Q–1. What changes to the rules of § 404 of the Code were made by PPA '06 for years beginning after December 31, 2005?

A–1. In general, PPA '06 amended § 404 to modify the deduction permitted for defined benefit pension plans under § 404(a)(1). PPA '06 also modified the combined limit on deductions for contributions to defined benefit plans and defined contribution plans with overlapping coverage as set forth in § 404(a)(7).

Q–2. To what years do the 2006 changes apply when the taxable year of the employer differs from the plan year of the plan?

A–2. The 2006 changes apply to taxable years of the employer beginning after December 31, 2005.

Under § 1.404(a)–14(c) of the Income Tax Regulations (regulations), if the plan year of the plan and the taxable year of the employer do not coincide, the deductible limit for the taxable year of the employer is permitted to be determined as any one of the following alternatives: (1) the deductible limit determined for the plan year beginning in the taxable year, (2) the deductible limit determined for the plan year ending in the taxable year, or (3) a weighted average of alternatives (1) and (2). A plan year used under any of these alternatives is referred to in this notice as an associated plan year.

The calculations of the deductible limit for a taxable year are based on the calculations with respect to an associated plan year or years and must reflect the law in effect for the taxable year. For example, with respect to the 2006 calendar taxable year, any associated plan year (*i.e.*, a plan year beginning in 2006 or plan year ending in 2006 that is used to determine the deductible limit for the 2006 taxable year) must reflect the 2006 changes. Thus, if the deductible limit is determined with respect to the plan year ending in 2006 (which begins in 2005), the calculation of the limit with respect to that plan year must reflect the use of an interest rate within the permissible corporate rate range (instead of an interest rate within the permissible 30-year Treasury rate range) (see Q&A–3 below) that was used for purposes of § 412, and must reflect the limitation based upon 150 percent of current liability (in place of the limitation based on 100 percent of current liability) under § 404(a)(1)(D). The funding method and other actuarial assumptions that were used for purposes of § 412 for that plan year must also be used for the calculations of the deductible limit.

As another example, in the case of a taxable year that is not the calendar year and that begins in 2005 and ends in 2006, and a plan year that is the calendar year, the deductible limit for any associated plan year must not reflect the 2006 changes. Thus, if the deductible limit for the taxable year beginning July 1, 2005, and ending June 30, 2006, is determined based upon the plan year beginning in the taxable year (the 2006 calendar plan year), the calculations of such limit must not reflect the limitation based on 150 percent of current liability (*i.e.*, must be limited to 100 percent of unfunded current liability) and may use the 30-year Treasury rate in place of the corporate rate.

Q–3. What changes to § 404(a)(1) of the Code were made by PPA '06 for years beginning after December 31, 2005?

A–3. In general, PPA '06 amended § 404(a)(1) of the Code for years beginning after December 31, 2005, to replace the limitation of § 404(a)(1)(D) based upon unfunded current liability with a limitation based on 150 percent of current liability (140 percent in the case of a multiemployer plan). In addition, PPA '06 eliminated the § 404(a)(1)(F) option to use any interest rate within 90 percent to 110 percent of the weighted average of the rates of interest on 30-year Treasury securities during the 4-year period ending on the last day before the beginning of the plan year (the permissible 30-year Treasury rate range) for purposes of determining current liability in determining the maximum deduction under § 404(a)(1) rather than an interest rate within the 90 percent to 100 percent of the weighted average of the rates of interest on amounts invested conservatively in long-term investment grade corporate

bonds (the permissible corporate rate range). The current liability is determined pursuant to existing guidance, including, for example, Notice 90–11, 1990–1 C.B. 319.

Q–4. When determining the deductible limit in accordance with the 2006 changes, is the deductible limit determined as of the valuation date for the plan year?

A–4. Yes, the deductible limit is determined as of the valuation date for the plan year and is adjusted for interest to the earlier of the end of the plan year or the end of the taxable year of the employer (the "relevant date"). See, for example, § 1.404(a)–14(f)(3) of the regulations.

Q–5. What does § 404(a)(1)(D)(ii) provide and is the adoption of a new plan treated as a plan amendment for purposes of § 404(a)(1)(D)(ii)?

A–5. Section 404(a)(1)(D)(ii) provides that, in the case of a plan which has 100 or fewer participants for the plan year, unfunded current liability shall not include the liability attributable to benefit increases for highly compensated employees (as defined in § 414(q), "HCEs") resulting from a plan amendment which is made or becomes effective, whichever is later, within the last two years. For purposes of § 404(a)(1)(D)(ii), the adoption of a new plan will not be treated as a plan amendment only if the employer did not maintain a defined benefit plan covering any HCE covered by the new plan during the past 2 years. Thus, for an employer with a taxable year that is the calendar year, if an HCE was covered by a defined benefit plan of the employer at any time during 2004 or 2005, a new plan established during the 2006 taxable year that covers that HCE would be considered a plan amendment for purposes of § 404(a)(1)(D)(ii).

Q–6. What changes to § 404(a)(7) were made by PPA '06 for years beginning after December 31, 2005?

A–6. In general, PPA '06 amended § 404(a)(7) of the Code for years beginning after December 31, 2005, to exclude multiemployer plans from consideration and to provide that the combined limit of § 404(a)(7) only applies in the case of employer contributions to one or more defined contribution plans to the extent that such contributions exceed 6 percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan.

Q–7. Is a plan that contains a qualified cash or deferred arrangement described in § 401(k) taken into account for purposes of the combined limit of § 404(a)(7)?

A–7. Yes, a plan that contains a qualified cash or deferred arrangement described in § 401(k) is taken into account for purposes of the combined limit of § 404(a)(7). However, pursuant to § 404(n), elective deferrals as defined in § 402(g)(3) are not taken into account. Thus, matching contributions and nonelective employer contributions are taken into account in applying the limits of § 404(a), including the combined limit of § 404(a)(7). If elective deferrals are the only contributions under a defined contribution plan, then the plan is not taken into account in applying the limits of § 404(a)(7).

Q–8. How does the combined limit of § 404(a)(7) apply when employer contributions to defined contribution plans (other than elective deferrals) exceed 6 percent of compensation of participants in those plans?

A–8. When employer contributions to defined contribution plans (other than elective deferrals) exceed 6 percent of compensation of participants in those plans, the amount of employer contributions to defined contribution plans to which the combined limit of § 404(a)(7) applies is equal to the amount of employer contributions for the plan year less 6 percent of compensation of participants in those plans. Thus, the combined limit of § 404(a)(7) (*i.e.*, the greater of 25 percent of compensation, or the contributions to the defined benefit plan or plans to the extent such contributions do not exceed the amount necessary to satisfy the minimum funding standard for the defined benefit plans, treating a contribution that does not exceed the unfunded current liability as an amount necessary to satisfy the minimum funding standard for each defined benefit plan) applies to the total of employer contributions to defined benefit plans and employer contributions to defined contribution plans (other than elective deferrals), less 6 percent of compensation of participants in the defined contribution plans.

Q–9. How does the combined limit of § 404(a)(7) apply when employer contributions to defined contribution plans (other than elective deferrals) do not exceed 6 percent of compensation of participants in those plans?

A–9. When employer contributions to defined contribution plans (other than elective deferrals) do not exceed 6 percent of compensation of participants in those plans, the combined limit of § 404(a)(7) does not apply to any employer contributions to defined contribution plans. In such a case, the combined limit of § 404(a)(7) (*i.e.*, the greater of 25 percent of compensation, or the contributions to the defined benefit plan or plans to the extent such contributions do not exceed the amount necessary to satisfy the minimum funding standard for the defined benefit plans, treating a contribution that does not exceed the unfunded current liability as an amount necessary to satisfy the minimum funding standard for each defined benefit plan) applies only to contributions to the defined benefit plans.

Drafting Information

The principal author of this notice is James E. Holland, Jr. of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, contact Mr. Holland at (202) 283–9699 (not a toll-free number).

Request for Comments and Interim Guidance Regarding Allocation of Costs Under the Simplified Methods of Accounting Under § 263A

Notice 2007–29

The Internal Revenue Service and Treasury Department are studying the appropriateness of the use of negative amounts in computing additional costs for purposes of the simplified methods of accounting under § 263A of the Internal Revenue Code. This notice invites public comment on changes to the simplified production method under § 1.263A–2(b) and the simplified resale method under § 1.263A–3(d) of the Income Tax Regulations. This notice also provides interim guidance pending the publication of future guidance.

BACKGROUND

Section 471 provides the general rules for inventories and authorizes the Secretary to determine when the use of inventories are necessary to clearly reflect income and to determine the valuation methods that are acceptable for tax purposes. The regulations under § 471 provide the general rules for the valuation of inventories.

Section 263A was enacted under the Tax Reform Act of 1986, and prescribes uniform capitalization rules for property produced or held for resale. Under § 263A, producers of real or tangible personal property and resellers of real or personal property must capitalize the direct costs and a proper share of the indirect costs of the property. Section 263A requires capitalization of indirect costs but generally does not set forth methods for allocating indirect costs. Instead, in accordance with the legislative history, the regulations under § 263A generally provide that taxpayers must allocate indirect costs to property using detailed or specific cost allocation methods, including a specific identification method, the standard cost method, and methods using burden rates. Alternatively, taxpayers may use the simplified production method or simplified resale method (simplified methods), as applicable.

The legislative history to § 263A indicates that Congress desired the Service to adopt a flexible approach in the § 263A regulations by providing simplified methods and assumptions when the costs and burdens of compliance may outweigh the benefits. Accordingly, the simplified methods are intended to alleviate the administrative burden of complying with the capitalization rules of § 263A.

In general, the simplified methods determine aggregate amounts of additional § 263A costs allocable to ending inventory. Additional § 263A costs generally are those costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of § 263A, but that are required to be capitalized under § 263A. Under the simplified methods, additional § 263A costs allocable to ending inventory are determined by multiplying § 471 costs (generally, the costs other than interest the taxpayer capitalized under its method of accounting immediately prior to the effective date of § 263A) remaining on hand at year end by an absorption ratio consisting of a numerator of additional § 263A costs incurred during the taxable year over a denominator of § 471 costs incurred during the taxable year.

At the time the § 263A regulations were issued, some commentators expressed concern that the simplified methods, in particular the simplified production method, would result in allocation of an excessive amount of § 263A costs to raw materials inventories. They suggested that this result occurs because the simplified production method does not take into account the fact that fewer indirect costs are incurred with respect to raw materials that are normally held only a short period of time, compared to other items of inventory held longer. The final regulations did not adopt these recommendations because the simplified production method formula properly reflects the costs of raw materials that are purchased on the last day of the year, and incorporating the suggestions would have reduced the simplicity that the simplified production method was intended to provide.

More recently, controversy has arisen regarding the inclusion of negative amounts in additional § 263A costs and whether aggregate additional § 263A costs may be a negative number. A negative amount may occur, for example, when a taxpayer includes book costs greater than those required for tax purposes in the § 471 cost of inventory. For example, if a taxpayer included book depreciation in § 471 costs in accordance with § 1.471–11(c)(2)(iii)(*b*) and the book depreciation is greater than tax depreciation for the year, the taxpayer may have capitalized too much depreciation for purposes of § 263A and must reduce total § 263A costs by the excess. A negative amount may result if the taxpayer does not adjust its § 471 costs to remove this excess depreciation amount but instead makes a negative adjustment to its additional § 263A costs. Some taxpayers have reasoned that allowing negative amounts is consistent with the purpose of the simplified methods to alleviate the administrative burden of complying with the capitalization rules of § 263A and may reduce overcapitalization that sometimes results.

The Service and Treasury Department are aware of this viewpoint but are concerned that including negative amounts in additional § 263A costs may result in significant distortions in some situations. Including negative amounts in additional § 263A costs may undercapitalize amounts because the simplified production method formula may remove more of the cost from ending inventory than was actually remaining in ending inventory. Generally, this distortion is caused by the use of a different formula for removing the cost from ending inventory than the formula by which the cost was originally capitalized under § 471. The inclusion of raw materials in the simplified production method formula also may cause distortions. For example, including a negative amount for book depreciation greater than tax depreciation (excess depreciation) in the simplified production method formula may reduce ending inventory by more than the amount of excess depreciation actually remaining in ending inventory. In some circumstances this distortion may be a reversal of the overcapitalization of excess tax depreciation over book depreciation in prior years, and thus, may not be a cause for concern. However, the inclusion can cause significant, lasting distortion in situations in which the taxpayer has a tax basis much lower than book basis in depreciable property.

The Service and Treasury Department are considering amending the regulations under § 263A to prohibit the use of some or all negative amounts in computing additional § 263A costs under the existing simplified methods and to provide a new alternative simplified method of cost allocation under § 263A. The Service and Treasury Department will consider a new method that would allow negative amounts in computing additional § 263A costs, avoid requiring changes to existing systems for determining § 471 costs, but reduce distortions. One option under consideration would treat costs related to raw materials differently from those related to work-in-process or finished goods. Another option would create distinctions based upon the type of cost, with certain permanent items such as basis differences being allocated using a separate formula. Additionally, the Service and Treasury Department are considering whether special rules should be

provided for smaller taxpayers to compute additional § 263A costs.

INTERIM GUIDANCE

Pending the issuance of additional published guidance, the Service will not challenge the inclusion of negative amounts in computing additional costs under § 263A or the permissibility of aggregate negative additional § 263A costs. These issues will not be raised in any taxable year ending on or before publication of the guidance, and, if already raised as an issue in examination or before Appeals or the Tax Court in a taxable year ending on or before March 12, 2007, the issue will not be pursued by the Service. In addition, pending further published guidance, the Service will not deny consent for changes in method of accounting solely on the basis that the proposed method involves the inclusion of negative amounts in computing additional costs under § 263A or the permissibility of aggregate negative additional § 263A costs. However, the Service will not grant a taxpayer permission to treat a cost as a negative additional § 263A cost unless the taxpayer already treats that cost as a § 471 cost. In other words, the Service will not approve a change in method of accounting to change the costs capitalized under § 471 to begin capitalizing a cost under § 471 and to remove the same cost from ending inventory by treating it as a negative additional § 263A cost. In addition, any taxpayers granted consent to make these changes will be required to conform their methods of accounting to any future published guidance.

REQUEST FOR COMMENTS

The Service and Treasury Department specifically request public comments on the following issues:

1. If only some negative amounts are appropriate in computing additional § 263A costs under the existing simplified methods, which costs should be allowed and under what circumstances? For example, should variances that were treated as top-side adjustments (aggregate adjustments to total ending inventory that are not allocated to each item or unit in ending inventory) before enactment of § 263A be treated differently from variances that first arose after enactment of § 263A? If negative amounts may be included in the numerator of the existing methods for some costs, should aggregate negative additional § 263A costs be prohibited or restricted? Should items that generate a permanent difference, such as basis differences, be allowed under the existing simplified methods, or should they be allocated using a different method?

2. If the use of negative amounts is restricted for certain costs or in certain situations as described in (1) above, what specific modifications should be made to the existing simplified methods to effect this result and how should the negative costs be allocated? Should a new, alternative simplified method be created to allocate the negative costs or all additional § 263A costs?

3. How might a new, alternative simplified method of allocating costs under § 263A be designed that could be used for all additional § 263A costs, positive or negative, in lieu of the existing simplified methods, that would treat costs related to raw materials (including raw material content of work-in-process and finished goods) differently from those related to work-in-process or finished goods (excluding raw material content) and achieve maximum simplicity while reducing distortions? In particular, comments are requested on (a) how costs, including variances and book-tax differences, should be allocated between raw materials, work-in-process and finished goods, (b) whether only purchasing costs should be allocated to raw materials, (c) whether purchasing, storage, and handling costs of raw materials should be allocated to raw materials, (d) whether § 471 costs should be adjusted for purchased raw materials in transit and beginning inventory, and (e) whether separate absorption ratios should be calculated for raw materials, work-in-process and finished goods, and, if so, how those ratios should be calculated.

4. Should the simplified methods be modified for small taxpayers and if so, how? In particular, how should any changes described above be applied to small taxpayers? What criteria should be used for determining whether a taxpayer is a small taxpayer?

Comments should be submitted in writing on or before July 2, 2007, and should include a reference to Notice 2007–29. Send submissions to: CC:PA:LDP:PR (Notice 2007–29), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (Notice 2007–29), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Alternatively, comments may be submitted electronically directly to the Service via the following e-mail address: *Notice.comments@irscounsel.treas.gov*. Please include "Notice 2007–29" in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is W. Thomas McElroy, Jr. of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information concerning this notice, contact Mr. McElroy at (202) 622–4970 (not a toll-free number).

Frivolous Positions

Notice 2007–30

PURPOSE

Positions that are the same as or similar to the positions listed in this notice are identified as frivolous for purposes of the penalty for a "frivolous tax return" under section 6702(a) of the Internal Revenue Code and the penalty for a "specified frivolous submission" under section 6702(b). Persons who file a purported return of tax, including an original or amended return, based on one or more of these positions are subject to a penalty of $5,000 if the purported return of tax does not contain information on which the substantial correctness of the self-assessed determination of tax may be judged or contains information that on its face indicates the self-assessed determination of tax is substantially incorrect. Likewise, persons who submit a "specified submission" (namely, a request for a collection due process hearing or an application for an installment agreement, offer-in-compromise, or Taxpayer Assistance Order) based on one or more of the

positions listed in this notice are subject to a penalty of $5,000. The penalty may also be applied if the purported return or any portion of the specified submission is not based on a position set forth in this notice, yet reflects a desire to delay or impede the administration of Federal tax laws for purposes of section 6702(a)(2)(B) or 6702(b)(2)(A)(ii).

BACKGROUND

Section 407 of Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, 120 Stat. 2922 (2006), amended section 6702 to increase the amount of the penalty for frivolous tax returns from $500 to $5,000 and to impose a penalty of $5,000 on any person who submits a "specified frivolous submission." A submission is a "specified frivolous submission" if it is a "specified submission" (defined in section 6702(b)(2)(B) as a request for a hearing under section 6320 or 6330 or an application under section 6159, 7122 or 7811) and any portion of the submission (i) is based on a position identified by the Secretary as frivolous or (ii) reflects a desire to delay or impede administration of the Federal tax laws. Section 6702 was further amended to add a new subsection (c) requiring the Secretary to prescribe a list of positions identified as frivolous. This notice contains the prescribed list.

DISCUSSION

Frivolous Positions. Positions that are the same as or similar to the following are frivolous.

1. Compliance with the internal revenue laws is voluntary or optional and not required by law, including arguments that:
    a. Filing a Federal tax or information return or paying tax is purely voluntary under the law, or similar arguments described as frivolous in Rev. Rul. 2007–20, 2007–14 I.R.B. 863.
    b. Nothing in the Internal Revenue Code imposes a requirement to file a return or pay tax, or that a person is not required to file a tax return or pay a tax unless the Internal Revenue Service responds to the person's questions, correspondence, or a request to identify a provision in the Code requiring the filing of a return or the payment of tax.
    c. There is no legal requirement to file a Federal income tax return because the instructions to Forms 1040, 1040A, or 1040EZ or the Treasury regulations associated with the filing of the forms do not display an OMB control number as required by the Paperwork Reduction Act of 1980, 44 U.S.C. § 3501 *et seq.*, or similar arguments described as frivolous in Rev. Rul. 2006–21, 2006–15 I.R.B. 745.
    d. Because filing a tax return is not required by law, the Service must prepare a return for a taxpayer who does not file one in order to assess and collect tax.
    e. A taxpayer has an option under the law to file a document or set of documents in lieu of a return or elect to file a tax return reporting zero taxable income and zero tax liability even if the taxpayer received taxable income during the taxable period for which the return is filed, or similar arguments described as frivolous in Rev. Rul. 2004–34, 2004–1 C.B. 619.
    f. An employer is not legally obligated to withhold income or employment taxes on employees' wages.
    g. A taxpayer may "untax" himself or herself at any time or revoke the consent to be taxed and thereafter not be subject to internal revenue taxes.
    h. Only persons who have contracted with the government by applying for a governmental privilege or benefit, such as holding a Social Security number, are subject to tax, and those who have contracted with the government may choose to revoke the contract at will.
    i. A taxpayer may lawfully decline to pay taxes if the taxpayer disagrees with the government's use of tax revenues, or similar arguments described as frivolous in Rev. Rul. 2005–20, 2005–1 C.B. 821.
    j. An administrative summons issued by the Service is *per se* invalid and compliance with a summons is not legally required.
2. The Internal Revenue Code is not law (or "positive law") or its provisions are ineffective or inoperative, including the sections imposing an income tax or requiring the filing of tax returns, because the provisions have not been implemented by regulations even though the provisions in question either (a) do not expressly require the Secretary to issue implementing regulations to become effective or (b) expressly require implementing regulations which have been issued.
3. A taxpayer's income is excluded from taxation when the taxpayer rejects or renounces United States citizenship because the taxpayer is a citizen exclusively of a State (sometimes characterized as a "natural-born citizen" of a "sovereign state"), that is claimed to be a separate country or otherwise not subject to the laws of the United States. This position includes the argument that the United States does not include all or a part of the physical territory of the 50 States and instead consists of only places such as the District of Columbia, Commonwealths and Territories (*e.g.*, Puerto Rico), and Federal enclaves (*e.g.*, Native American reservations and military installations), or similar arguments described as frivolous in Rev. Rul. 2004–28, 2004–1 C.B. 624, or Rev. Rul. 2007–22, 2007–14 I.R.B. 866.
4. Wages, tips, and other compensation received for the performance of personal services are not taxable income or are offset by an equivalent deduction for the personal services rendered, including an argument that a taxpayer has a "claim of right" to exclude the cost or value of the taxpayer's labor from income or that taxpayers have a basis in their labor equal to the fair market value of the wages they receive, or similar arguments described as frivolous in Rev. Rul. 2004–29, 2004–1 C.B. 627, or Rev. Rul. 2007–19, 2007–14 I.R.B. 843.
5. United States citizens and residents are not subject to tax on their wages

or other income derived from sources within the United States, as only foreign-based income or income received by nonresident aliens and foreign corporations from sources within the United States is taxable, and similar arguments described as frivolous in Rev. Rul. 2004–30, 2004–1 C.B. 622.

6. A taxpayer has been removed or redeemed from the Federal tax system though the taxpayer remains a United States citizen or resident, or similar arguments described as frivolous in Rev. Rul. 2004–31, 2004–1 C.B. 617.
7. Only certain types of taxpayers are subject to income and employment taxes, such as employees of the Federal government, corporations, nonresident aliens, or residents of the District of Columbia or the Federal territories, or similar arguments described as frivolous in Rev. Rul. 2006–18, 2006–15 I.R.B. 743.
8. Only certain types of income are taxable, for example, income that results from the sale of alcohol, tobacco, or firearms or from transactions or activities that take place in interstate commerce.
9. Federal income taxes are unconstitutional or a taxpayer has a constitutional right not to comply with the Federal tax laws for one of the following reasons:
   a. The First Amendment permits a taxpayer to refuse to pay taxes based on religious or moral beliefs.
   b. A taxpayer may withhold payment of taxes or the filing of a tax return until the Service or other government entity responds to a First Amendment petition for redress of grievances.
   c. Mandatory compliance with, or enforcement of, the tax laws invades a taxpayer's right to privacy under the Fourth Amendment.
   d. The requirement to file a tax return is an unreasonable search and seizure contrary to the Fourth Amendment.
   e. Income taxation, tax withholding, or the assessment or collection of tax is a "taking" of property without due process of law or just compensation in violation of the Fifth Amendment.
   f. The Fifth Amendment privilege against self-incrimination grants taxpayers the right not to file returns or the right to withhold all financial information from the Service.
   g. Mandatory or compelled compliance with the internal revenue laws is a form of involuntary servitude prohibited by the Thirteenth Amendment.
   h. Individuals may not be taxed unless they are "citizens" within the meaning of the Fourteenth Amendment.
   i. The Sixteenth Amendment was not ratified, has no effect, contradicts the Constitution as originally ratified, lacks an enabling clause, or does not authorize a non-apportioned, direct income tax.
   j. Taxation of income attributed to a trust, which is a form of contract, violates the constitutional prohibition against impairment of contracts.
   k. Similar constitutional arguments described as frivolous in Rev. Rul. 2005–19, 2005–1 C.B. 819.
10. A taxpayer is not a "person" within the meaning of section 7701(a)(14) or other provisions of the Internal Revenue Code, or similar arguments described as frivolous in Rev. Rul. 2007–22, 2007–14 I.R.B. 866.
11. Federal Reserve Notes are not taxable income when paid to a taxpayer because they are not gold or silver and may not be redeemed for gold or silver.
12. In a transaction using gold and silver coins, the value of the coins is excluded from income or the amount realized in the transaction is the face value of the coins and not their fair market value for purposes of determining taxable income.
13. A taxpayer with a home-based business may deduct as business expenses the costs of maintaining the taxpayer's household along with personal expenses, or similar arguments described as frivolous by Rev. Rul. 2004–32, 2004–1 C.B. 621.
14. A "reparations" tax credit exists, including arguments that African-American taxpayers may claim a tax credit on their Federal income tax returns as reparations for slavery or other historical mistreatment, that Native Americans are entitled to an analogous credit (or are exempt from Federal income tax on the basis of a treaty), or similar arguments described as frivolous in Rev. Rul. 2004–33, 2004–1 C.B. 628, or Rev. Rul. 2006–20, 2006–15 I.R.B. 746.
15. A Native American or other taxpayer who is not an employer engaged in a trade or business may nevertheless claim (for example, in an amount exceeding all reported income) the Indian Employment Credit under section 45A, which explicitly requires, among other criteria, that the taxpayer be an employer engaged in a trade or business to claim the credit.
16. A taxpayer's wages are excluded from Social Security taxes if the taxpayer waives the right to receive Social Security benefits, or a taxpayer is entitled to a refund of, or may claim a charitable-contribution deduction for, the Social Security taxes that the taxpayer has paid, or similar arguments described as frivolous in Rev. Rul. 2005–17, 2005–1 C.B. 823.
17. Taxpayers may reduce or eliminate their Federal tax liability by altering a tax return, including striking out the penalty-of-perjury declaration, or attaching documents to the return, such as a disclaimer of liability, or similar arguments described as frivolous in Rev. Rul. 2005–18, 2005–1 C.B. 817.
18. A taxpayer is not obligated to pay income tax because the government has created an entity separate and distinct from the taxpayer—a "straw man"—that is distinguishable from the taxpayer by some variation of the taxpayer's name, and any tax obligations are exclusively those of the "straw man," or similar arguments described as frivolous in Rev. Rul. 2005–21, 2005–1 C.B. 822.
19. Inserting the phrase "nunc pro tunc" on a return or other document filed with or submitted to the Service has a legal effect, such as reducing a tax-

payer's tax liability, or similar arguments described as frivolous in Rev. Rul. 2006–17, 2006–15 I.R.B. 748.

20. A taxpayer may avoid tax on income by attributing the income to a trust, including the argument that a taxpayer can put all of the taxpayer's assets into a trust to avoid income tax while still retaining substantial powers of ownership and control over those assets or that a taxpayer may claim an expense deduction for the income attributed to a trust, or similar arguments described as frivolous in Rev. Rul. 2006–19, 2006–15 I.R.B. 749.
21. A taxpayer may lawfully avoid income tax by sending income offshore, including depositing income into a foreign bank account.
22. By purchasing equipment and services for an inflated price (which may or may not have been actually paid), a taxpayer can use the section 44 Disabled Access Credit to reduce tax or generate a refund irrespective of whether the taxpayer is a small business that purchased the equipment or services to comply with the requirements of the Americans with Disabilities Act.
23. A taxpayer is allowed to buy or sell the right to claim a child as a qualifying child for purposes of the Earned Income Tax Credit.
24. An IRS Form 23C, *Assessment Certificate — Summary Record of Assessments*, is an invalid record of assessment for purposes of section 6203 and Treas. Reg. § 301.6203–1, the Form 23C must be personally signed by the Secretary of the Treasury for an assessment to be valid, the Service must provide a copy of the Form 23C to a taxpayer if requested before taking collection action, or similar arguments described as frivolous in Rev. Rul. 2007–21, 2007–14 I.R.B. 865.
25. A tax assessment is invalid because the assessment was made from a section 6020(b) substitute for return, which is not a valid return.
26. A statutory notice of deficiency is invalid because the taxpayer to whom the notice was sent did not file an income tax return reporting the deficiency or because the statutory notice of deficiency was unsigned or not signed by the Secretary of the Treasury or by someone with delegated authority.
27. A Notice of Federal Tax Lien is invalid because it is not signed by a particular official (such as by the Secretary of the Treasury), or because it was filed by someone without delegated authority.
28. The form or content of a Notice of Federal Tax Lien is controlled by or subject to a state or local law, and a Notice of Federal Tax Lien that does not comply in form or content with a state or local law is invalid.
29. A collection due process notice under section 6320 or 6330 is invalid if it is not signed by the Secretary of the Treasury or other particular official, or if no certificate of assessment is attached.
30. Verification under section 6330 that the requirements of any applicable law or administrative procedure have been met may only be based on one or more particular forms or documents (which must be in a certain format), such as a summary record of assessment, or that the particular forms or documents or the ones on which verification was actually determined must be provided to a taxpayer at a collection due process hearing.
31. A Notice and Demand is invalid because it was not signed, was not on the correct form (*e.g.*, a Form 17), or was not accompanied by a certificate of assessment when mailed.
32. The United States Tax Court is an illegitimate court or does not, for any purported constitutional or other reason, have the authority to hear and decide matters within its jurisdiction.
33. Federal courts may not enforce the internal revenue laws because their jurisdiction is limited to admiralty or maritime cases or issues.
34. Revenue Officers are not authorized to issue levies or Notices of Federal Tax Lien or to seize property in satisfaction of unpaid taxes.
35. A Service employee lacks the authority to carry out the employee's duties because the employee does not possess a certain type of identification or credential, for example, a pocket commission or a badge, or it is not in the correct form or on the right medium.
36. A person may represent a taxpayer before the Service or in court proceedings even if the person does not have a power of attorney from the taxpayer, has not been enrolled to practice before the Service, or has not been admitted to practice before the court.
37. A civil action to collect unpaid taxes or penalties must be personally authorized by the Secretary of the Treasury and the Attorney General.
38. A taxpayer's income is not taxable if the taxpayer assigns or attributes the income to a religious organization (a "corporation sole" or ministerial trust) claimed to be tax-exempt under section 501(c)(3), or similar arguments described as frivolous in Rev. Rul. 2004–27, 2004–1 C.B. 625.
39. The Service is not an agency of the United States government but rather a private-sector corporation or an agency of a State or Territory without authority to administer the internal revenue laws.
40. Any position described as frivolous in any revenue ruling or other published guidance in existence when the return adopting the position is filed with or the specified submission adopting the position is submitted to the Service.

Returns or submissions that contain positions not listed above, which on their face have no basis for validity in existing law, or which have been deemed frivolous in a published opinion of the United States Tax Court or other court of competent jurisdiction, may be determined to reflect a desire to delay or impede the administration of Federal tax laws and thereby subject to the $5,000 penalty.

The list of frivolous positions above will be periodically revised as required by section 6702(c).

DRAFTING INFORMATION

The principal author of this notice is the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this notice, contact the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions & Judicial Practice Division, Branch 2, 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, § 527.)

Rev. Proc. 2007–27

SECTION 1. BACKGROUND

.01 Section 527 of the Internal Revenue Code provides for the tax treatment of all political organizations. Section 527(e) provides that a political organization is an organization (whether or not incorporated) organized and operated primarily for the purpose of accepting contributions or making expenditures to influence, or attempt to influence, the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office, office in a political party or the election of Presidential or Vice-Presidential electors.

.02 Under § 527(i), certain political organizations must file Form 8871, *Political Organization Notice of Section 527 Status*, within 24 hours of being established and within 30 days of any material change to information reported on Form 8871 to be treated as tax-exempt § 527 organizations. Until these political organizations file the form, their income (including income that would otherwise be treated as exempt function income) is subject to taxation pursuant to § 527(i)(4). See Section I of Rev. Rul. 2003–49, 2003–1 C.B. 903.

.03 Under § 527(j), certain tax-exempt political organizations must report periodically on Form 8872, *Political Organization Report of Contributions and Expenditures*, information about contributions received and expenditures made by the organizations. These reports are due either monthly or semi-annually in odd-numbered years and either monthly or quarterly in even-numbered years. In addition, certain pre- and post-election reports are required. Information required to be reported includes the names and addresses of contributors, and, for individual contributors, their occupations and employers. A tax-exempt political organization that fails to include the required information is liable under § 527(j)(1) for the payment of an amount equal to the amount of the contribution or expenditure multiplied by the highest corporate tax rate (currently 35%). See Section II of Rev. Rul. 2003–49, 2003–1 C.B. 903.

.04 Section 527(l) provides that the Internal Revenue Service may waive all or any portion of the tax assessed due to a failure to comply with § 527(i) or the amount imposed under § 527(j) if the failure was due to reasonable cause and not due to willful neglect. In establishing reasonable cause, the key factor to consider is the extent of the organization's effort to obtain and report the required information. If the organization establishes to the Service's satisfaction that there are significant mitigating factors with respect to the failure, the failure arose from events beyond the organization's control, or the organization has exercised the appropriate level of due diligence to obtain and report the required information, waiver is appropriate.

.05 Political organizations have requested guidance on what steps a political organization needs to take to establish that its failure to disclose required information was due to reasonable cause and not due to willful neglect.

SECTION 2. FORM 8872 SCHEDULE A SAFE HARBOR

.01 This revenue procedure provides a "safe harbor" for establishing that failure to report certain contributor information on Form 8872 was due to reasonable cause and not due to willful neglect, and therefore qualifies for relief under § 527(l)(2) of the Code. The safe harbor will apply only to those contributions for which a political organization establishes that it meets the requirements of the safe harbor. For example, if a political organization fails to report required information with respect to contribution X and contribution Y on a Form 8872, and the political organization meets the safe harbor criteria for contribution X, but not contribution Y, the organization qualifies for relief pursuant to the safe harbor with respect to contribution X, but not contribution Y. In addition, the safe harbor will not apply in situations where the organization fails to report the name of the contributor on Form 8872 by the time prescribed. For each contribution for which the requirements of the safe harbor are satisfied, the Service will waive the full amount imposed under section 527(j) with respect to the contribution.

.02 A failure to report the address of a contributor and, if the contributor is an individual, the occupation and employer of the contributor will be considered to be due to reasonable cause and not due to willful neglect provided that all of the following requirements are met:

(1) All fundraising solicitations by (or on behalf of) the tax-exempt political organization contain a clear request (in a conspicuous and easily recognizable format) for the contributor's address and, if the contributor is an individual, the contributor's occupation and employer (consistent with the instructions for Form 8872) and include a statement that the political organization is subject to Federal taxes and penalties if it fails to disclose this information to the Service. A fundraising solicitation includes any solicitation of contributions or gifts in written (including electronically such as via the internet or by facsimile or email) or printed form, by television or radio, or by telephone.

(2) For each contribution for which the contributor has not provided the required information, such as the contributor's address, occupation and employer, the tax-exempt political organization makes a written (including electronically such as via the internet or by facsimile or email) request, or an oral request memorialized in writing, to the contributor for the required information within 30 days of receipt of the contribution. The information request may thank the contributor for the contribution, but must not include material on any other subject or an additional solicitation. Each information request must include a statement that the tax-exempt political organization is subject to Federal taxes and penalties if it fails to disclose this information to the Service. In addition, each information request that is not oral or electronic must include a pre-addressed return envelope or postcard. Each oral or electronic information request must include the mailing or Internet address to which the required information should be submitted instead of a pre-addressed return envelope or postcard.

(3) If the contributor has not responded to the information request by the due date of the Form 8872 and in the tax-exempt political organization's records, including contributor records, fundraising records or previously filed Forms 8872, the tax-exempt political organization has information about the contributor that is requested by the Form

8872, the organization must report such information on the Form 8872.

(4) If any missing or corrected contributor information is received after the contribution has been disclosed on Form 8872, the tax-exempt political organization files an amended Form 8872 including the additional information within 30 days of receipt of the information, unless the information is received less than 30 days and more than 2 business days before an election, in which case the tax-exempt political organization files an amended Form 8872 including the additional information no later than 2 business days before the election.

(5) The tax-exempt political organization discloses all the required information on Forms 8872 with respect to at least 85 percent of the total dollar amount of contributions it received during the calendar year.

(6) The political organization keeps contemporaneous records sufficient to substantiate that it has complied with subparagraphs (1) through (5) in this section.

.03 Even if a tax-exempt political organization does not meet the requirements of the safe harbor, the Service still may exercise its authority under section 527(l) if it determines that the failure is due to reasonable cause and not willful neglect.

SECTION 3. REQUEST FOR COMMENTS

.01 The Service is considering whether to publish additional guidance concerning the application of § 527(l) to a political organization that fails to file a completed Form 8871 or Form 8872 in the time and manner prescribed. The Service requests public comment concerning (1) the need for additional guidance and (2) circumstances in which such a failure should be deemed to be due to reasonable cause and not due to willful neglect. For example, under § 6724 and the regulations thereunder, a failure to comply with certain information reporting requirements is deemed to be due to reasonable cause and not due to willful neglect if the filer acted in a responsible manner and either there are significant mitigating factors with respect to the failure or the failure arose from events beyond the filer's control. The regulations under § 6724 provide examples of acting in a responsible manner, significant mitigating factors and events beyond the organization's control. However, the Service recognizes that the reporting requirements under § 527 have significant public disclosure and timeliness concerns (particularly in relation to public disclosure prior to elections) that may differentiate them from other information reporting requirements. Thus, comments should address the following questions:

(1) In applying § 527(l), how might the factors similar to those in the regulations under § 6724 be adapted for purposes of § 527(l)?

(a) Are there any significant mitigating factors that are unique to failures to file Form 8871 or Form 8872 in the time and manner prescribed?

(b) Are there any events beyond the political organization's control that are unique to failures to file Form 8871 or Form 8872 in the time and manner prescribed?

(c) Are there any factors unique to political organizations that should be considered in determining whether a political organization acted in a responsible manner, both before and after a failure to file Form 8871 or Form 8872 in the time and manner prescribed?

(2) Are there any factors relevant to determining whether all or only a portion of the amounts assessed should be waived?

(3) What documentation should the political organization maintain to establish that any failure to file Form 8871 or Form 8872 in the time and manner prescribed was due to reasonable cause and not due to willful neglect?

(4) Are there factors that indicate relief under § 527(l) should not be granted?

.02 Public comments should be submitted in writing on or before July 2, 2007.

Comments should be sent to the following address:

Internal Revenue Service
SE:T:EO:RA:G (Rev. Proc. 2007–27)
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Comments may be hand delivered to:

SE:T:EO:RA:G (Rev. Proc. 2007–27)
Courier's Desk
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

Comments may also be sent electronically via the Internet to *notice.comments@irscounsel.treas.gov*. Please include "Rev. Proc. 2007–27" in the subject line.

All comments will be available for public inspection.

SECTION 4. DRAFTING INFORMATION

The principal author of this notice is Judith E. Kindell of Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this notice, contact Judith E. Kindell at (202) 283–8964 (not a toll-free call).

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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