

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. 2008-47, page 760.

Interest rates; underpayments and overpayments. The rates of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 2008, will be 6 percent for overpayments (5 percent in the case of a corporation), 6 percent for underpayments, and 8 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 will be 3.5 percent.

T.D. 9420, page 750.

Final regulations under section 42 of the Code, concerning the low-income housing tax credit, update the utility allowances regulations to provide new options for estimating tenant utility costs.

REG-120844-07, page 770.

Proposed regulations under section 460 of the Code would amend the regulations as they apply to certain long-term construction contracts that qualify as home construction contracts under section 460(e)(6) and to certain changes in method of accounting for long-term contracts. A public hearing is scheduled for December 5, 2008.

REG-106251-08, page 774.

Proposed regulations under section 423 of the Code provide the requirements that must be satisfied in order for a plan to meet the definition of an employee stock purchase plan. Section 423 also addresses the individual income tax treatment of stock acquired pursuant to an option granted under an employee stock purchase plan. The regulations update the existing regulations and provide additional guidance in certain areas.

Notice 2008-76, page 768.

This notice addresses the application of section 382 of the Code in the case of certain acquisitions made pursuant to the Housing and Economic Recovery Act of 2008.

EMPLOYEE PLANS

REG-106251-08, page 774.

Proposed regulations under section 423 of the Code provide the requirements that must be satisfied in order for a plan to meet the definition of an employee stock purchase plan. Section 423 also addresses the individual income tax treatment of stock acquired pursuant to an option granted under an employee stock purchase plan. The regulations update the existing regulations and provide additional guidance in certain areas.

EXEMPT ORGANIZATIONS

Rev. Proc. 2008-55, page 768.

This procedure provides guidance with respect to the classification of Indian tribal entities that the Service recognizes as Indian Tribal Governments under sections 7701(a)(40) and 7871 of the Code. The procedure has been coordinated with a list of federally recognized tribes published by the Department of Interior, Bureau of Indian Affairs. Rev. Proc. 2002-64 superseded.

(Continued on the next page)

Finding Lists begin on page ii.
Index for July through September begins on page v.



ESTATE TAX

T.D. 9421, page 755.

Final regulations under section 2642(a)(3) of the Code provide guidance regarding the generation-skipping transfer (GST) tax consequences of the severance of a trust in a manner that is effective under state law, but that does not meet the requirements of a qualified severance under section 2642(a)(3). The regulations also provide guidance regarding the GST tax consequences of a qualified severance of a trust with an inclusion ratio between zero and one into more than two resulting trusts. In addition, the regulations provide special funding rules applicable to the non-*pro rata* division of certain assets between or among resulting trusts.

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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For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

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

Section 42.—Low-Income Housing Credit

26 CFR 1.42–10: Utility allowances.

T.D. 9420

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Section 42 Utility Allowance Regulations Update

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations that amend the utility allowances regulations concerning the low-income housing tax credit. The final regulations update the utility allowance regulations to provide new options for estimating tenant utility costs. The final regulations affect owners of low-income housing projects who claim the credit, the tenants in those low-income housing projects, and the State and local housing credit agencies that administer the credit.

DATES: *Effective Date:* These regulations are effective July 29, 2008.

Applicability Date: For dates of applicability, see §1.42–12(a)(4).

FOR FURTHER INFORMATION CONTACT: David Selig (202) 622–3040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) relating to the low-income housing credit under section 42 of the Internal Revenue Code (Code). On June 19, 2007, the IRS and Treasury Department published in the **Federal Register** proposed

regulations under section 42(g)(2)(B)(ii) (REG–128274–03, 2007–33 I.R.B. 356 [72 FR 33703]). Written and electronic comments responding to the proposed regulations were received and a public hearing was held on the proposed regulations on October 9, 2007. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision.

General Overview

Section 42(a) provides that, for purposes of section 38, the amount of the low-income housing credit determined under section 42 for any taxable year in the credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building. A qualified low-income building is defined in section 42(c)(2) as any building that is part of a qualified low-income housing project.

A qualified low-income housing project is defined in section 42(g)(1) as any project for residential rental property if the project meets one of the following tests elected by the taxpayer: (1) at least 20 percent of the residential units in the project are rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income; or (2) at least 40 percent of the residential units in the project are rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income. If a taxpayer does not meet the elected test, the project is not eligible for the section 42 credit.

Under section 42(g)(4), section 142(d)(2)(B) applies when determining whether any project is a qualified low-income housing project under section 42(g)(1). Section 142(d)(2)(B) provides that the income of individuals and area median gross income is determined by the Secretary in a manner consistent with determinations of lower income families and area median gross income under section 8 of the United States Housing Act of 1937. Under Rev. Rul. 94–57, 1994–2 C.B. 5, taxpayers may rely on a list of income limits released by the Department of Housing and Urban Development (HUD)

until 45 days after HUD releases a new list of income limits, or until HUD's effective date for the new list, whichever is later.

In order to qualify as a rent-restricted unit within the meaning of section 42(g)(2), the gross rent for the unit must not exceed 30 percent of the imputed income limitation applicable to the unit. Section 42(g)(2)(B)(ii) requires the inclusion in gross rent of a utility allowance determined by the Secretary after taking into account the determinations under section 8 of the United States Housing Act of 1937.

Section 1.42–10(a) provides that if utility costs (other than telephone) for a residential rental unit are paid directly by the tenant, then the gross rent for that unit includes the applicable utility allowance as determined under § 1.42–10. Section 1.42–10(b) provides rules for calculating the appropriate utility allowance based upon whether (1) the building receives rental assistance from the Farmers Home Administration (FmHA), now known as the Rural Housing Service; (2) the building has any tenant that receives FmHA rental assistance; (3) the building is not described in (1) or (2) above and the building's rents and utility allowances are reviewed by HUD on an annual basis; or (4) the building is not described in (1), (2), or (3) above (other buildings).

Currently, under §1.42–10(b)(4), other buildings generally use the applicable Public Housing Authority (PHA) utility allowance established for the Section 8 Existing Housing Program or use a local utility company estimate. The local utility company estimate may be obtained by any interested party (including a low-income tenant, a building owner, or a State or local housing credit agency (Agency)).

The proposed regulations proposed two additional options for calculating utility allowances. The first option would permit a building owner to obtain a utility estimate for each unit in a building from the Agency that has jurisdiction over the building (the Agency estimate). The Agency estimate must take into account the local utility rates data, property type, climate variables by region in the State, taxes and fees on utility charges,

and property building materials and mechanical systems. An Agency may also use actual utility company usage data and rates for the building. The second option would permit a building owner to calculate utility allowances using the “HUD Utility Schedule Model” found on the Low-Income Housing Tax Credits page at www.huduser.org/datasets/lihtc.html (or successor URL). The HUD Utility Schedule Model is based on data from the Residential Energy Consumption Survey (RECS) conducted by the Department of Energy. RECS data provides energy consumption by structure for heating, air conditioning, cooking, water heating, and other electric (lighting and refrigeration). The HUD Utility Schedule Model incorporates building location and climate.

Summary of Comments and Explanation of Changes

Exclusions from utility allowance

Prior to these final regulations, §1.42–10(a) provided for the exclusion of telephone costs in determining the amount of the utility allowance to be included in gross rent. The proposed regulations excluded cable television costs as well as telephone costs. The final regulations retain the exclusions for cable television and telephone costs and also exclude Internet costs. The IRS and Treasury Department believe it is appropriate to exclude cable television and Internet costs as comparable to telephone costs.

Additional option for determining utility allowances

Commentators stated that the Agency estimate in the proposed regulations may be administratively burdensome for some Agencies. As an alternative, commentators suggested adding an option that would allow utility estimates to be calculated by a state-certified engineer or other qualified professional. The commentators specified that, under this option, computer software could be developed that would estimate the energy or water and sanitary sewer service cost for each type of unit in a building. The estimates would be determined based on the applicable current local utility billing rate schedule and would be applied to all comparable units in the building using spe-

cific information about the design, materials, equipment, and location of the building.

A computer software model that incorporates specific information about the design and location of the building for which the utility allowances are being developed, and that can be updated with actual consumption data and with consumption estimates as new efficiency measures and improvements are undertaken, would provide more accurate estimates of utility consumption. Therefore, the final regulations also include a new option allowing building owners to retain the services of a qualified professional to calculate utility allowances based on an energy consumption model.

The use of this new option is subject to several special rules. First, the energy consumption model must, at a minimum, take into account specific factors including, but not limited to, unit size, building orientation, design and materials, mechanical systems, appliances, and characteristics of the building location. Second, the utility estimates must be calculated by either (1) a properly licensed engineer or (2) a qualified professional approved by the Agency that has jurisdiction over the building (together, qualified professional). The qualified professional and the building owner must not be related within the meaning of section 267(b) or 707(b). Third, the building owner must furnish a copy of the estimates derived from the energy consumption model to the Agency and make copies of the estimates available to all tenants in the building. Finally, the building owner must pay for all costs incurred in obtaining the utility estimates from the qualified professional and providing the estimates to the Agency and tenants.

Default option/option ordering

One commentator suggested that the final regulations should provide a default option because, in the absence of a definitive standard for determining utility allowances, building owners would use the option that yields the lowest utility estimates. Commentators further requested clarification as to which option should be used when multiple options are available, whether building owners may use different options for different utilities, and whether

owners may change the options used for calculating utilities from time to time.

An energy consumption model developed by a qualified professional that takes into account specific information about the design and location of the building for which the utility allowances are being developed should produce the most accurate utility estimates. It is expected that this more accurate model will be the model most commonly used by most building owners, particularly those with buildings that are not very old. However, if a building owner selects an option that yields higher utility allowances, the building owner should be free to accept a lower amount of rent from tenants. Therefore, there is no need for a stated default option or option ordering rule. Further, the final regulations neither prohibit using different options for different utilities nor prohibit changing the options used for calculating utilities. If an Agency determines that a building owner has understated the utility allowances for the building under the particular option chosen by the owner for calculating the utility allowance, and the building’s units are not rent-restricted units under section 42(g)(2) as a result, the Agency must report the noncompliance on Form 8823, *Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition*.

Application of newly calculated utility allowances

Under current §1.42–10(c) of the regulations, if the applicable utility allowance for units changes, the new utility allowance must be used to compute gross rent of rent-restricted units due 90 days after the change (the 90-day period). The proposed regulations limited the effective date of any new utility allowances to the earlier of the date the building has achieved 90 percent occupancy for a period of 90 consecutive days or the end of the first year of the credit period. The proposed regulations also modified §1.42–10(c) by requiring that a building owner must review at least annually the basis on which utility allowances have been established and must update the applicable utility allowance. The review must take into account any changes to the building such as any energy conservation

measures that affect energy consumption and changes in utility rates.

Commentators suggested that building owners should be obligated to adjust utility allowances when utility rates increase by a stated percentage, for example, 10 percent, which is the rule for revising utility allowance schedules for PHAs under 24 CFR 982.517(c). This HUD rule provides that a PHA must review its schedule of utility allowances each year and revise its allowance for a utility category if the utility rate has changed by 10 percent or more since the utility allowance schedule was last revised. The commentators did not address decreases in utility rates. A commentator also suggested that the final regulations should require an Agency to review or have owners review local utility rates quarterly to determine if rates have increased sufficiently to require an adjustment. A different commentator suggested limiting reviews to no more than once per year.

The IRS and Treasury Department do not believe that fluctuations in utility rates within a given year should trigger recalculations of utility allowances more than once a year. The IRS and Treasury Department do not believe that the additional burden of updating the utility allowances more than once a year is warranted at this time. Utility rates generally do not change more than once a year, and yearly updated utility allowances would reflect average rates applicable to all tenants in a building from year to year. Therefore, the final regulations require building owners to calculate new utility allowances once during the calendar year regardless of any percentage change in utility rates. Building owners may choose, however, to calculate new utility allowances more frequently than once during the calendar year provided the owner complies with the requirements of these regulations, including the notification requirements to the Agency and tenants.

Another commentator suggested that new utility allowances should be implemented within 90 days after HUD publishes its annual income limits (which are used in determining section 42 rents), but in no case later than June 30 of any year. Section 42 rents under section 42(g)(2) may or may not increase depending on HUD's calculation of area median gross income. Therefore, the IRS and Treasury

Department do not believe that the rules should require that the effective date of any new utility allowance coincide with the section 42 effective date of HUD's income lists. Building owners, however, may choose to implement any new utility allowances on the section 42 effective date of HUD's income lists.

To bring financial stability to a project during the beginning of its operations, the final regulations clarify that the building owner is not required to review the utility allowances, or implement new utility allowances, until the earlier of the date the building has achieved 90 percent occupancy for a period of 90 consecutive days or the end of the first year of the credit period.

Procedural safeguards for tenants

One commentator made several recommendations regarding procedural safeguards for tenants including: owners should be required to give tenants 30 days notice before the effective date of any utility allowance; tenants should be provided with all information used in calculating the utility allowances; tenants should be given the opportunity to comment on the proposed allowances; and owners should be required to review those comments prior to the utility allowances becoming effective. The commentator believed that the new options for determining utility allowances should be available only after one full year of occupancy and one full year after the building is placed in service. A commentator also recommended that a building owner should be allowed to use the new options only if the owner provides all data to the Agency no later than February 15 and the Agency informs the owner whether the proposed utility allowances are approved by March 31.

To provide tenants with the opportunity to comment on proposed utility allowances to the Agency and building owner, the final regulations apply the existing disclosure requirement under current §1.42-10(b)(4)(ii)(B) (regarding the utility company estimate) to an owner using a utility company estimate, the HUD Utility Schedule Model, or an energy consumption model. Therefore, an owner must submit copies of the proposed utility allowances to the Agency and make the proposed utility allowances available to

all tenants in the building at the beginning of the 90-day period before the utility allowances are used in determining the gross rents of rent-restricted units. Similarly, the final regulations require that any utility estimates obtained under the Agency estimate option must be made available to all tenants in the building at the beginning of the 90-day period. An Agency may continue to require additional information from the owner during the 90-day period.

Commentators suggested that the final regulations should limit the use of the HUD Utility Schedule Model to data for a twelve-month period ending in the most recent calendar year and require the owner to certify the accuracy of the data and the calculations of the utility allowances. However, the HUD Utility Schedule Model already incorporates consumption data derived from RECS data. Thus, building owners using this option need not be required to use consumption data for any particular twelve-month period. These final regulations, however, provide that the use of the energy consumption model is limited to consumption data for a twelve-month period ending no earlier than 60 days prior to the beginning of the 90-day period. In the case of newly constructed or renovated buildings with less than twelve months of consumption data, the energy consumption model allows a qualified professional to use consumption data for the twelve-month period of units of similar size and construction in the geographic area in which the building containing the units is located. Further, the final regulations require that utility rates used for the HUD Utility Schedule Model, the Agency estimate option, and the energy consumption model must be no older than the rates in place 60 days prior to the beginning of the 90-day period.

In addition to these safeguards, if an Agency determines that a building owner has understated the utility allowances for the owner's building under the particular option chosen, and, therefore, some or all of the units in the building are not rent-restricted units under section 42(g)(2), then the Agency must report the noncompliance to the Service on Form 8823, *Low-Income Housing Credit Agencies Report of Non-compliance or Building Disposition*.

Commentators requested that building owners should be required to certify the estimate and the accuracy of the data used

under the new options. Because Agencies may request additional information at any time during their mandatory review of proposed utility allowances, and must report any noncompliance to the Service, the final regulations do not require building owners to provide such certification.

Utility allowances for tenants with special needs

One commentator suggested that the calculation of utility allowances should take into account any special needs tenants such as people with disabilities who require high energy consumption equipment. Section 42 does not require that the owner's calculation of utility allowances be based on a tenant's particular use of utility services. If such a requirement were imposed, owners and Agencies would have to determine the utility allowance for the tenants in each unit, as opposed to allowances based on the size of the unit, which would greatly increase burden. Additionally, it is unclear whether it is appropriate to implement rules that might encourage tenants to be indifferent to their energy consumption. Such indifference could lead to cost overruns by owners, and the viability of low-income housing could be jeopardized. Therefore, the final regulations do not require the calculation of utility allowances based on consumption by particular tenants.

Calculation of utility company estimate option for deregulated utilities

Section 1.42-10(b)(4)(ii)(B) currently provides that any interested party (including an owner, low-income tenant, or Agency) may obtain a local utility company estimate for a unit. The estimate is obtained when the interested party receives, in writing, information from a local utility company providing the estimated cost of that utility for a unit of similar size and construction for the geographic area in which the building containing the units is located. In light of utility services deregulation, the proposed regulations proposed to amend this option by requiring the interested party to obtain cost estimates from the local utility company that include combined rate charges from multiple utility companies.

Commentators thought this proposed amendment would require the interested

party to obtain utility consumption estimates from every utility company providing the same utility service and stated that this would present an unworkable administrative burden in deregulated jurisdictions with multiple utility providers. In some jurisdictions, many utility providers may be available for a given building. The proposed amendment was not intended to require the interested party to obtain utility consumption estimates from every utility company providing the same utility service. The amendment was proposed to address deregulation by requiring the interested party to obtain estimates for all the components of the utility service if the service is divided between two or more types of service providers (for example, electric generation and electric transmission). The final regulations clarify that, in the case of deregulated utility services, the interested party is required to obtain an estimate from only one utility company even if multiple companies can provide the same utility service to a unit. However, the utility company furnishing the estimate must offer utility services to the building in order for that utility company's rates to be used in calculating utility allowances. The estimate should include all component charges for providing the utility service.

Agency costs/administrative burden

One commentator requested that specific language be added to address when Agencies may charge a reasonable fee for making a determination pursuant to the Agency estimate option, and who bears the fee when a particular option is used. The proposed regulations provided that costs incurred in obtaining an Agency estimate are borne by the building owner. The final regulations adopt this provision, and further require building owners to pay for all costs incurred in obtaining the estimates under the HUD Utility Schedule Model and the energy consumption model and in providing estimates to Agencies and tenants.

Effective/applicability date

The proposed regulations were proposed to be effective for taxable years beginning on or after the date of publication of the final regulations in the **Federal Register**. A commentator suggested that

the final regulations be effective earlier on the basis that if they are published after 2007, they would not be effective until 2009 for calendar year taxpayers. The IRS and Treasury Department believe that the burden associated with an earlier effective date is not warranted. Therefore, the final regulations do not adopt this suggestion. However, in order to allow a building owner to implement the utility allowances as of the first day of the owner's taxable year beginning on or after July 29, 2008, the final regulations provide that taxpayers may rely on the rules for determining utility allowances before the first day of the owner's taxable year beginning on or after July 29, 2008 provided that any utility allowances so calculated are effective no earlier than the first day of the owner's taxable year beginning on or after July 29, 2008.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the information has previously been reviewed and approved under OMB control number 1545-1102, and that the information required by these final regulations adds no new burden to the existing requirements. Accordingly, a Regulatory Flexibility Analysis under the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is David Selig, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury

Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.42–10 is amended by:

1. Revising the first sentence of paragraph (a).

2. Revising paragraphs (b)(1), (b)(2), and (b)(3), and the introductory text of paragraph (b)(4).

3. Adding two sentences at the end of paragraph (b)(4)(ii)(A).

4. Adding three sentences after the second sentence in paragraph (b)(4)(ii)(B).

5. Adding paragraphs (b)(4)(ii)(C), (b)(4)(ii)(D), and (b)(4)(ii)(E).

6. Revising paragraph (c).

7. Adding paragraph (d).

The additions and revisions read as follows:

§1.42–10 Utility allowances.

(a) * * * If the cost of any utility (other than telephone, cable television, or Internet) for a residential rental unit is paid directly by the tenant(s), and not by or through the owner of the building, the gross rent for that unit includes the applicable utility allowance determined under this section. * * *

(b) *Applicable utility allowances—(1) Buildings assisted by the Rural Housing Service.* If a building receives assistance from the Rural Housing Service (RHS-assisted building), the applicable utility allowance for all rent-restricted units in the building is the utility allowance determined under the method prescribed by the Rural Housing Service (RHS) for the building (whether or not the building or its tenants also receive other state or federal assistance).

(2) *Buildings with Rural Housing Service assisted tenants.* If any tenant in a building receives RHS rental assistance payments (RHS tenant assistance), the ap-

plicable utility allowance for all rent-restricted units in the building (including any units occupied by tenants receiving rental assistance payments from the Department of Housing and Urban Development (HUD)) is the applicable RHS utility allowance.

(3) *Buildings regulated by the Department of Housing and Urban Development.* If neither a building nor any tenant in the building receives RHS housing assistance, and the rents and utility allowances of the building are reviewed by HUD on an annual basis (HUD-regulated building), the applicable utility allowance for all rent-restricted units in the building is the applicable HUD utility allowance.

(4) *Other buildings.* If a building is neither an RHS-assisted nor a HUD-regulated building, and no tenant in the building receives RHS tenant assistance, the applicable utility allowance for rent-restricted units in the building is determined under the following methods.

* * * * *

(i) * * * (A) * * * However, if a local utility company estimate is obtained for any unit in the building under paragraph (b)(4)(ii)(B) of this section, a State or local housing credit agency (Agency) provides a building owner with an estimate for any unit in a building under paragraph (b)(4)(ii)(C) of this section, a cost estimate is calculated using the HUD Utility Schedule Model under paragraph (b)(4)(ii)(D) of this section, or a cost estimate is calculated by an energy consumption model under paragraph (b)(4)(ii)(E) of this section, then the estimate under paragraph (b)(4)(ii)(B), (C), (D), or (E) becomes the applicable utility allowance for all rent-restricted units of similar size and construction in the building. Paragraphs (b)(4)(ii)(B), (C), (D), and (E) of this section do not apply to units to which the rules of paragraphs (b)(1), (2), (3), or (4)(i) of this section apply.

(B) * * * In the case of deregulated utility services, the interested party is required to obtain an estimate only from one utility company even if multiple companies can provide the same utility service to a unit. However, the utility company must offer utility services to the building in order for that utility company's rates to be used in calculating utility allowances. The estimate should include all component dereg-

ulated charges for providing the utility service. * * *

(C) *Agency estimate.* A building owner may obtain a utility estimate for each unit in the building from the Agency that has jurisdiction over the building provided the Agency agrees to provide the estimate. The estimate is obtained when the building owner receives, in writing, information from the Agency providing the estimated per-unit cost of the utilities for units of similar size and construction for the geographic area in which the building containing the units is located. The Agency estimate may be obtained by a building owner at any time during the building's extended use period (see section 42(h)(6)(D)). Costs incurred in obtaining the estimate are borne by the building owner. In establishing an accurate utility allowance estimate for a particular building, an Agency (or an agent or other private contractor of the Agency that is a qualified professional within the meaning of paragraph (b)(4)(ii)(E) of this section) must take into account, among other things, local utility rates, property type, climate and degree-day variables by region in the State, taxes and fees on utility charges, building materials, and mechanical systems. If the Agency uses an agent or other private contractor to calculate the utility estimates, the agent or contractor and the owner must not be related within the meaning of section 267(b) or 707(b). An Agency may also use actual utility company usage data and rates for the building. However, use of the Agency estimate is limited to the building's consumption data for the twelve-month period ending no earlier than 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section and utility rates used for the Agency estimate must be no older than the rates in place 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section. In the case of newly constructed or renovated buildings with less than 12 months of consumption data, the Agency (or an agent or other private contractor of the Agency that is a qualified professional within the meaning of paragraph (b)(4)(ii)(E) of this section) may use consumption data for the 12-month period of units of similar size and construction in the geographic area in which the building containing the units is located.

(D) *HUD Utility Schedule Model.* A building owner may calculate a utility estimate using the “HUD Utility Schedule Model” that can be found on the Low-Income Housing Tax Credits page at www.huduser.org/datasets/lihtc.html (or successor URL). Utility rates used for the HUD Utility Schedule Model must be no older than the rates in place 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section.

(E) *Energy consumption model.* A building owner may calculate utility estimates using an energy and water and sewage consumption and analysis model (energy consumption model). The energy consumption model must, at a minimum, take into account specific factors including, but not limited to, unit size, building orientation, design and materials, mechanical systems, appliances, and characteristics of the building location. The utility consumption estimates must be calculated by either a properly licensed engineer or a qualified professional approved by the Agency that has jurisdiction over the building (together, qualified professional), and the qualified professional and the building owner must not be related within the meaning of section 267(b) or 707(b). Use of the energy consumption model is limited to the building’s consumption data for the twelve-month period ending no earlier than 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section, and utility rates used for the energy consumption model must be no older than the rates in place 60 days prior to the beginning of the 90-day period under paragraph (c)(1) of this section. In the case of newly constructed or renovated buildings with less than 12 months of consumption data, the qualified professional may use consumption data for the 12-month period of units of similar size and construction in the geographic area in which the building containing the units is located.

(c) *Changes in applicable utility allowance—(1) In general.* If, at any time during the building’s extended use period (as defined in section 42(h)(6)(D)), the applicable utility allowance for units changes, the new utility allowance must be used to compute gross rents of the units due 90 days after the change (the 90-day period). For example, if rent must be

lowered because a local utility company estimate is obtained that shows a higher utility cost than the otherwise applicable PHA utility allowance, the lower rent must be in effect for rent due at the end of the 90-day period. A building owner using a utility company estimate under paragraph (b)(4)(ii)(B) of this section, the HUD Utility Schedule Model under paragraph (b)(4)(ii)(D) of this section, or an energy consumption model under paragraph (b)(4)(ii)(E) of this section must submit copies of the utility estimates to the Agency that has jurisdiction over the building and make the estimates available to all tenants in the building at the beginning of the 90-day period before the utility allowances can be used in determining the gross rent of rent-restricted units. An Agency may require additional information from the owner during the 90-day period. Any utility estimates obtained under the Agency estimate under paragraph (b)(4)(ii)(C) of this section must also be made available to all tenants in the building at the beginning of the 90-day period. The building owner must pay for all costs incurred in obtaining the estimates under paragraphs (b)(4)(ii)(B), (C), (D), and (E) of this section and providing the estimates to the Agency and the tenants. The building owner is not required to review the utility allowances, or implement new utility allowances, until the building has achieved 90 percent occupancy for a period of 90 consecutive days or the end of the first year of the credit period, whichever is earlier.

(2) *Annual review.* A building owner must review at least once during each calendar year the basis on which utility allowances have been established and must update the applicable utility allowance in accordance with paragraph (c)(1) of this section. The review must take into account any changes to the building such as any energy conservation measures that affect energy consumption and changes in utility rates.

(d) *Record retention.* The building owner must retain any utility consumption estimates and supporting data as part of the taxpayer’s records for purposes of §1.6001-1(a).

Par. 3. Section 1.42-12 is amended by adding paragraph (a)(4) to read as follows:

§1.42-12 Effective dates and transitional rules.

(a) * * *

(4) *Utility allowances.* The first sentence in §1.42-10(a), §1.42-10(b)(1), (2), (3), and (4), the last two sentences in §1.42-10(b)(4)(ii)(A), the third, fourth, and fifth sentences in §1.42-10(b)(4)(ii)(B), §1.42-10(b)(4)(ii)(C), (D), and (E), and §1.42-10(c) and (d) are applicable to a building owner’s taxable years beginning on or after July 29, 2008. Taxpayers may rely on these provisions before the beginning of the building owner’s taxable year beginning on or after July 29, 2008 provided that any utility allowances calculated under these provisions are effective no earlier than the first day of the building owner’s taxable year beginning on or after July 29, 2008. The utility allowances provisions that apply to taxable years beginning before July 29, 2008 are contained in §1.42-10 (see 26 CFR part 1 revised as of April 1, 2008).

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

Approved July 20, 2008.

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

(Filed by the Office of the Federal Register on July 28, 2008, 8:45 a.m., and published in the issue of the Federal Register for July 29, 2008, 73 F.R. 43863)

Section 2642.—Inclusion Ratio

26 CFR 2642-6: Qualified severance.

T.D. 9421

Department of the Treasury Internal Revenue Service 26 CFR Part 26

Severance of a Trust for Generation-Skipping Transfer (GST) Tax Purposes

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

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance regarding the generation-skipping transfer (GST) tax consequences of the severance of a trust in a manner that is effective under state law, but that does not meet the requirements of a qualified severance under section 2642(a)(3) of the Internal Revenue Code (Code). These final regulations also provide guidance regarding the GST tax consequences of a qualified severance of a trust with an inclusion ratio between zero and one into more than two resulting trusts. These final regulations also provide special funding rules applicable to the non-*pro rata* division of certain assets between or among resulting trusts. The regulations will affect trusts that are subject to the GST tax.

DATES: *Effective Date:* The regulations are effective July 31, 2008.

Applicability Date: For dates of applicability, see §26.2642-6(k)(1).

FOR FURTHER INFORMATION CONTACT: Mayer R. Samuels, (202) 622-3090 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 2642(a)(3) was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Public Law 107-16 (115 Stat. 38 (2001)). Under section 2642(a)(3), if a trust is divided into two or more trusts in a “qualified severance,” the separate trusts resulting from the severance (resulting trusts), which may have different inclusion ratios, will be recognized as separate trusts for GST tax purposes. (As used in this guidance, “resulting trust” has no relation to a resulting trust recognized under the common law of trusts and principles of equity.) Once the resulting trusts are recognized as separate trusts, the transferor’s lifetime GST tax exemption may be allocated separately to either trust. In addition, whether or not a GST taxable event occurs is determined separately for each resulting trust.

On August 24, 2004, proposed regulations under section 2642(a)(3) regarding qualified severances were published in

the **Federal Register** (REG-145987-03, 2004-2 C.B. 523 [69 FR 51967]). Final regulations were published on August 2, 2007 (T.D. 9348, 2007-37 I.R.B. 563 [72 FR 42291]). The Treasury Department and IRS determined that certain comments received in response to the proposed regulations, and certain additional rules under section 2642(a)(3), should be addressed in a separate notice of proposed rulemaking. On August 2, 2007, the **Federal Register** published a notice of proposed rulemaking (REG-128843-05, 2007-37 I.R.B. 587 [72 FR 42340]) addressing those comments and rules. The IRS received one submission containing several comments on the notice of proposed rulemaking. The comments contained in the submission are discussed below. No public hearing was requested or held.

Explanation of Provisions and Summary of Comments

Section 26.2642-6(d)(4) of the existing regulations provides that each of the trusts resulting from a qualified severance must be funded with a fraction or percentage of the original trust, and that the sum of those fractions or percentages must be one or one hundred percent, respectively. The existing regulations provide that this requirement may be satisfied by the funding of each resulting trust with that trust’s fraction or percentage share of each asset held by the original trust (a *pro rata* division). Section 26.2642-6(d)(4) of the proposed regulations permits the funding of the resulting trusts on a non-*pro rata* basis, provided that a special funding rule is also satisfied. Specifically, this section of the proposed regulations provides that, if the assets of the original trust are divided between or among the resulting trusts on a non-*pro rata* basis, no discounts or other reductions from the value of the asset owned by the original trust, arising by reason of the division of the original trust’s interest in the asset between or among the resulting trusts, are permitted for purposes of determining the amount used to fund each resulting trust. Instead, solely for funding purposes, each resulting trust’s interest in the stock of a closely held corporation, partnership interest, or other asset must be valued by multiplying the fair market value of the asset held in the original trust as of the date of severance by the

fractional or percentage interest in that asset being distributed to that resulting trust. Thus, for purposes of the requirements of a qualified severance, regardless of whether the funding is done on a *pro rata* basis, the cumulative value of the resulting trusts equals the value of the original trust.

The commentators pointed out that funding pursuant to this rule would result in an allocation different from the allocation that would normally be obtained from funding based on the state law fair market value standard which would take the discounts into account. The commentators expressed concern that the resulting shift in beneficial interests between or among the resulting trusts could violate the trustee’s fiduciary duty of impartiality under applicable state law. Further, the commentators pointed out that the proposed rule could be avoided through the post-severance purchase and sale of assets between resulting trusts at fair market value. The commentators recommended an alternative funding rule under which the value of the original trust would be calculated as the sum of the fair market value of the assets to be held by the resulting trusts.

This recommendation was not adopted in the final regulations. It is difficult to see how the fiduciary duty of impartiality is challenged more by this funding rule than by a *pro rata* division of each asset of the original trust. The funding rule in the proposed regulations was intended to facilitate the funding of the resulting trusts without the cost or need for review of appraisals of each severed interest, and thus to improve the administrability of the severance provisions. This funding rule produces a bright line test, the same result whether or not the trust assets are divided on a *pro rata* basis, and recognizes that in many circumstances, where a trust is severed for tax purposes into two identical trusts with the same or related beneficiaries, any closely held stock or partnership units divided between the two resulting trusts are likely to be sold as a unit without any actual reduction in value that may be reflected in the claimed discounts. Any use of post-severance sales between resulting trusts to avoid these funding rules may constitute mere steps in a pre-arranged transaction.

The commentators pointed out that the nonqualified severance illustrated in

§26.2642-6(j), *Example 3*, of the existing regulations will result in a taxable event for GST tax purposes (that is, a taxable termination or taxable distribution) if that severance occurs on or after the proposed regulations are adopted as final. This is because, under the proposed regulations, the severed trust is treated as a separate trust for GST tax purposes. Accordingly, cautionary language has been added to this example to the effect that a GST taxable event will result as a consequence of the severance.

It was determined that §26.2642-6(j), *Example 12* of the proposed regulations addresses the same issue covered in *Example 8* of §26.2654-1(a)(5). Therefore, *Example 12* has been removed from the final regulations and the examples have been renumbered accordingly.

As requested by the commentators, a new example, §26.2642-6(j), *Example 13*, has been added to confirm that a trust resulting from a nonqualified severance may subsequently be severed in a qualified severance.

The commentators noted that the proposed regulations under §26.2654-1(a)(1)(iii) address the treatment of severances resulting in separate trusts that are required under the terms of a trust instrument (mandatory severances) but that are neither severances otherwise recognized under section 2654 nor qualified severances under section 2642. The proposed regulations conclude that the separate shares or trusts resulting from such a severance, if recognized as separate trusts under state law, will be recognized as separate for GST tax purposes. The commentators questioned why the proposed changes to the regulations under section 2654 must address those severances that result in separate trusts when this issue is already addressed in §26.2642-6(h) of the proposed regulations dealing with nonqualified severances. Section 26.2654-1(a)(1)(iii) was intended to address only mandatory severances that, as with the other types of severances covered by §26.2654-1(a), are dictated by the terms of the trust. On the other hand, §26.2642-6(h) addresses discretionary severances, that is, severances that are elective and within the discretion of the trustee. The severances described in §26.2654-1 are governed by that section.

Therefore, the proposed addition to this section has not been removed.

The proposed regulations under section 2654 state a general rule that separate shares or trusts resulting from a mandatory severance, that are recognized as separate trusts for GST tax purposes, will not be treated as separate trusts for purposes of filing income tax returns or calculating any other taxes. The comments noted that this statement should not apply to shares or trusts that are recognized as separate trusts under local law. Rather, this statement should apply only to separate shares created within a single trust that are not recognized under local law as separate trusts. The final regulations reflect this change.

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) applies only to §26.2642-6(d)(7)(iii) of these regulations. It is hereby certified that this provision will not have a significant economic impact on a substantial number of small entities. Accordingly, a Regulatory Flexibility Analysis is not required. This provision directly affects individuals, not entities. Because the remaining sections of these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these final regulations is Mayer R. Samuels, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. Other personnel from the IRS and Treasury participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 26 is amended as follows:

PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

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

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

Par. 2. In §26.2600-1, the table of contents is amended by adding the entry for §26.2642-6(h) to read as follows:

§26.2600-1 *Table of contents.*

* * * * *

§26.2642-6 *Qualified severance.*

* * * * *

(h) Treatment of trusts resulting from a severance that is not a qualified severance.

* * * * *

Par. 3. Section 26.2642-6 is amended as follows:

1. Paragraphs (d)(4) and (d)(7) are revised.

2. Paragraph (h) is added.

3. Paragraph (j) *Example 3* is revised.

4. Paragraph (j) *Examples 6, 9, 12, and 13* are added.

5. Paragraph (k)(1) is revised.

The additions and revisions read as follows:

§26.2642-6 *Qualified severance.*

* * * * *

(d) * * *

(4) The single trust (original trust) is severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or one hundred percent, respectively. For this purpose, the fraction or percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to the transferor's unused GST tax exemption, and the denominator of which is the fair market value of the original trust's assets on the date of severance).

The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust is not a qualified severance if the trust is divided into two trusts, with one trust to be funded with \$1,500,000 and the other trust to be funded with the balance of the original trust's assets. With respect to the particular assets to be distributed to each separate trust resulting from the severance, each such trust may be funded with the appropriate fraction or percentage (*pro rata* portion) of each asset held by the original trust. Alternatively, the assets may be divided among the resulting trusts on a non-*pro rata* basis, based on the fair market value of the assets on the date of severance. However, if a resulting trust is funded on a non-*pro rata* basis, each asset received by a resulting trust must be valued, solely for funding purposes, by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fraction or percentage of that asset received by that resulting trust. Thus, the assets must be valued without taking into account any discount or premium arising from the severance, for example, any valuation discounts that might arise because the resulting trust receives less than the entire interest held by the original trust. See paragraph (j), *Example 6* of this section.

* * * * *

(7)(i) In the case of a qualified severance occurring after GST tax exemption has been allocated to the trust (whether by an affirmative allocation, a deemed allocation, or an automatic allocation pursuant to the rules contained in section 2632), if the trust has an inclusion ratio as defined in §26.2642-1 that is greater than zero and less than one, then either paragraph (d)(7)(ii) or (iii) of this section must be satisfied.

(ii) The trust is severed initially into only two resulting trusts. One resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction, as defined in §26.2642-1(b) and (c), used to determine the inclusion ratio of the original trust immediately before the severance. The other resulting trust must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of

one over the fractional share described in the preceding sentence. The trust receiving the fractional share equal to the applicable fraction shall have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then, with respect to the two equal trusts resulting from the severance, the trustee may designate which of the resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one. Each separate trust resulting from the severance then may be further divided in accordance with the rules of this section. See paragraph (j), *Example 7*, of this section.

(iii) The trust is severed initially into more than two resulting trusts. One or more of the resulting trusts in the aggregate must receive that fractional share of the total value of the original trust as of the date of severance that is equal to the applicable fraction used to determine the inclusion ratio of the original trust immediately before the severance. The trust or trusts receiving such fractional share shall have an inclusion ratio of zero, and each of the other resulting trust or trusts shall have an inclusion ratio of one. (If, however, two or more of the resulting trusts each receives the fractional share of the total value of the original trust equal to the applicable fraction, the trustee may designate which of those resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one.) The resulting trust or trusts with an inclusion ratio of one must receive in the aggregate that fractional share of the total value of the original trust as of the date of severance that is equal to the excess of one over the fractional share described in the second sentence of this paragraph. See paragraph (j), *Example 9*, of this section.

* * * * *

(h) *Treatment of trusts resulting from a severance that is not a qualified severance.* Trusts resulting from a severance (other than a severance recognized for GST tax purposes under §26.2654-1) that does not meet the requirements of a qualified severance under paragraph (b) of this section will be treated, after the date of severance, as separate trusts for purposes of the GST tax, provided that the trusts resulting from such severance are recognized as separate trusts under applicable state law. The

post-severance treatment of the resulting trusts as separate trusts for GST tax purposes generally permits the allocation of GST tax exemption, the making of various elections permitted for GST tax purposes, and the occurrence of a taxable distribution or termination with regard to a particular resulting trust, with no GST tax impact on any other trust resulting from that severance. Each trust resulting from a severance described in this paragraph (h), however, will have the same inclusion ratio immediately after the severance as that of the original trust immediately before the severance. (See §26.2654-1 for the inclusion ratio of each trust resulting from a severance described in that section.) Further, any trust resulting from a nonqualified severance may be severed subsequently, pursuant to a qualified severance described in this §26.2642-6.

* * * * *

(j) * * *

Example 3. Severance based on actuarial value of beneficial interests. In 2004, T establishes Trust, an irrevocable trust providing that income is to be paid to T's child C during C's lifetime. Upon C's death, Trust is to terminate and the assets of Trust are to be paid to GC, C's child, if living, or, if GC is not then living, to GC's estate. T properly elects, under section 2632(c)(5), not to have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, and T does not otherwise allocate GST tax exemption with respect to Trust. Thus, Trust has an inclusion ratio of one. In 2009, the trustee of Trust, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 for the benefit of C (and on C's death to C's estate), and Trust 2 for the benefit of GC (and on GC's death to GC's estate). The document severing Trust directs that Trust 1 is to be funded with an amount equal to the actuarial value of C's interest in Trust prior to the severance, determined under section 7520 of the Internal Revenue Code. Similarly, Trust 2 is to be funded with an amount equal to the actuarial value of GC's interest in Trust prior to the severance, determined under section 7520. Trust 1 and Trust 2 do not provide for the same succession of interests as provided under the terms of the original trust. Therefore, the severance is not a qualified severance. Furthermore, because the severance results in no non-skip person having an interest in Trust 2, Trust 2 constitutes a skip person under section 2613 and, therefore, the severance results in a taxable termination subject to GST tax.

* * * * *

Example 6. Funding of severed trusts on a non-pro rata basis. (i) T's will establishes an irrevocable trust (Trust) for the benefit of T's descendants. As a result of the allocation of GST tax exemption, the applicable fraction with respect to Trust is .60 and Trust's inclusion ratio is .40 [1 - .60]. Pursuant to authority granted under applicable state law, on August 1, 2008, the trustee executes a document severing Trust into two trusts, Trust 1 and Trust 2, each of

which is identical to Trust. The instrument of severance provides that the severance is intended to qualify as a qualified severance within the meaning of section 2642(a)(3) and designates August 3, 2008, as the date of severance (within the meaning of paragraph (d)(3) of this section). The instrument further provides that Trust 1 and Trust 2 are to be funded on a non-*pro rata* basis with Trust 1 funded with assets having a fair market value on the date of severance equal to 40% of the value of Trust's assets on that date and Trust 2 funded with assets having a fair market value equal to 60% of the value of Trust's assets on that date. The fair market value of the assets used to fund each trust is to be determined in compliance with the requirements of paragraph (d)(4) of this section.

(ii) On August 3, 2008, the fair market value of the Trust assets totals \$4,000,000, consisting of 52% of the outstanding common stock in Company, a closely-held corporation, valued at \$3,000,000 and \$1,000,000 in cash and marketable securities. Trustee proposes to divide the Company stock equally between Trust 1 and Trust 2, and thus transfer 26% of the Company stock to Trust 1 and 26% of the stock to Trust 2. In addition, the appropriate amount of cash and marketable securities will be distributed to each trust. In accordance with paragraph (d)(4) of this section, for funding purposes, the interest in the Company stock distributed to each trust is valued as a *pro rata* portion of the value of the 52% interest in Company held by Trust before severance, without taking into account, for example, any valuation discount that might otherwise apply in valuing the noncontrolling interest distributed to each resulting trust.

(iii) Accordingly, for funding purposes, each 26% interest in Company stock distributed to Trust 1 and Trust 2 is valued at \$1,500,000 (.5 x \$3,000,000). Therefore, Trust 1, which is to be funded with \$1,600,000 (.40 x \$4,000,000), receives \$100,000 in cash and marketable securities valued as of August 3, 2008, in addition to the Company stock, and Trust 2, which is to be funded with \$2,400,000 (.60 x \$4,000,000), receives \$900,000 in cash and marketable securities in addition to the Company stock. Therefore, the severance is a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied.

Example 9. Regulatory qualified severance. (i) In 2004, T establishes an *inter vivos* irrevocable trust (Trust) providing that trust income is to be paid annually in equal shares to T's children, A and B, for 10 years. Trust provides that the trustee has discretion to make additional distributions of principal to A and B during the 10-year term without adjustments to their shares of income or the trust remainder. If either (or both) dies prior to the expiration of the 10-year term, the deceased child's share of trust income is to be paid to the child's then living descendants, per stirpes, for the balance of the trust term. At the expiration of the 10-year term, the corpus is to be distributed equally to A and B; if A and B (or either or them) is not then living, then such decedent's share is to be distributed instead to such decedent's then living descendants, per stirpes. T allocates GST tax exemption to Trust such that Trust's applicable fraction is .25 and its inclusion ratio is .75.

(ii) In 2006, pursuant to applicable state law, the trustee severs the trust into three trusts: Trust 1, Trust

2, and Trust 3. The instrument severing Trust provides that Trust 1 is to receive 50% of Trust's assets, Trust 2 is to receive 25% of Trust's assets, and Trust 3 is to receive 25% of Trust's assets. All three resulting trusts are identical to Trust, except that each has different beneficiaries: A and A's issue are designated as the beneficiaries of Trust 1, and B and B's issue are designated as the beneficiaries of Trust 2 and Trust 3. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 1 will have an inclusion ratio of 1. Because both Trust 2 and Trust 3 have each received the fractional share of Trust's assets equal to Trust's applicable fraction of .25, trustee designates that Trust 2 will have an inclusion ratio of one and that Trust 3 will have an inclusion ratio of zero.

Example 12. Other severance that does not meet the requirements of a qualified severance. (i) In 2004, T establishes an irrevocable *inter vivos* trust (Trust) providing that Trust income is to be paid to T's children, A and B, in equal shares for their joint lives. Upon the death of the first to die of A and B, all Trust income will be paid to the survivor of A and B. At the death of the survivor, the corpus is to be distributed in equal shares to T's grandchildren, W and X (with any then-deceased grandchild's share being paid in accordance with that grandchild's testamentary general power of appointment). W is A's child and X is B's child. T elects under section 2632(c)(5) not to have the automatic allocation rules contained in section 2632(c) apply with respect to T's transfers to Trust, but T allocates GST tax exemption to Trust resulting in Trust having an inclusion ratio of .30.

(ii) In 2009, the trustee of Trust, as permitted by applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that trust income is to be paid to A for life and, on A's death, the remainder is to be distributed to W (or pursuant to W's testamentary general power of appointment). Trust 2 provides that trust income is to be paid to B for life and, on B's death, the remainder is to be distributed to X (or pursuant to X's testamentary general power of appointment). Because Trust 1 and Trust 2 do not provide A and B with the contingent survivor income interests that were provided to A and B under the terms of Trust, Trust 1 and Trust 2 do not provide for the same succession of interests in the aggregate as provided by Trust. Therefore, the severance does not satisfy the requirements of this section and is not a qualified severance. Provided that Trust 1 and Trust 2 are recognized as separate trusts under applicable state law, Trust 1 and Trust 2 will be recognized as separate trusts for GST tax purposes pursuant to paragraph (h) of this section, prospectively from the date of the severance. However, Trust 1 and Trust 2 each have an inclusion ratio of .30 immediately after the severance, the same as the inclusion ratio of Trust prior to severance.

Example 13. Qualified severance following a non-qualified severance. Assume the same facts as in *Example 12*, except that, as of November 4, 2010, the trustee of Trust 1 severs Trust 1 into two trusts, Trust 3 and Trust 4, in accordance with applicable local law. The instrument severing Trust 1 provides that both resulting trusts have provisions identical to Trust 1. The terms of the instrument severing Trust 1 further provide that Trust 3 is to be funded on a *pro*

rata basis with assets having a fair market value as of the date of severance equal to 70% of the value of Trust 1's assets on that date, and Trust 4 is to be funded with assets having a fair market value as of the date of severance equal to 30% of the value of Trust 1's assets on that date. The severance constitutes a qualified severance, provided that all other requirements of section 2642(a)(3) and this section are satisfied. Trust 3 will have an inclusion ratio of zero and Trust 4 will have an inclusion ratio of one.

(k) * * *

(1) *In general.* Except as otherwise provided in this paragraph (k), this section applies to severances occurring on or after August 2, 2007. Paragraph (d)(7)(iii), paragraph (h), and *Examples 9, 12 and 13* of paragraph (j) of this section apply to severances occurring on or after September 2, 2008.

Par. 4. Section 26.2654-1 is amended as follows:

1. Paragraph (a)(1)(i) is revised.
2. Paragraph (a)(1)(iii) is added.
3. In paragraph (a)(5), *Example 8* is revised.
4. Paragraph (d) is added.

The additions and revisions read as follows:

§26.2654-1 *Certain trusts treated as separate trusts.*

(a) * * *(1) * * *(i) * * * If a single trust consists solely of substantially separate and independent shares for different beneficiaries, the share attributable to each beneficiary (or group of beneficiaries) is treated as a separate trust for purposes of Chapter 13. The phrase "substantially separate and independent shares" generally has the same meaning as provided in §1.663(c)-3. However, except as provided in paragraph (a)(1)(iii) of this section, a portion of a trust is not a separate share unless such share exists from and at all times after the creation of the trust. For purposes of this paragraph (a)(1), a trust is treated as created at the date of death of the grantor if the trust is includible in its entirety in the grantor's gross estate for Federal estate tax purposes. Further, except with respect to shares or trusts that are treated as separate trusts under local law, treatment of a single trust as separate trusts under this paragraph (a)(1) does not permit treatment of those portions as separate trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code. Also, additions to, and distributions from,

such trusts are allocated *pro rata* among the separate trusts, unless the governing instrument expressly provides otherwise. See §26.2642-6 and paragraph (b) of this section regarding the treatment, for purposes of Chapter 13, of separate trusts resulting from the discretionary severance of a single trust.

* * * * *

(iii) *Mandatory severances.* For purposes of this section, if the governing instrument of a trust requires the division or severance of a single trust into separate trusts upon the future occurrence of a particular event not within the discretion of the trustee or any other person, and if the trusts resulting from such a division or severance are recognized as separate trusts under applicable state law, then each resulting trust is treated as a separate trust for purposes of Chapter 13. For this purpose, the rules of paragraph (b)(1)(ii)(C) of this section apply with respect to the severance and funding of the trusts. Similarly, if the governing instrument requires the division of a single trust into separate shares under the circumstances described in this paragraph, each such share is treated as a separate trust for purposes of Chapter 13. The post-severance treatment of the resulting shares or trusts as separate trusts for GST tax purposes generally permits the allocation of GST tax exemption, the making of various elections permitted for GST tax purposes, and the occurrence of a taxable distribution or termination with regard to a particular resulting share or trust, with no GST tax impact on any other trust or share resulting from that severance. The treatment of a single trust as separate trusts under this paragraph (a)(1), however, does not permit treatment of those portions as separate trusts for purposes of filing returns and payment of tax or for purposes of computing any other tax imposed under the Internal Revenue Code, if those portions are not treated as separate trusts under local law. Also, additions to, and distributions from, such trusts are allocated *pro rata* among the separate trusts, unless the governing instrument expressly provides otherwise. Each separate share and each trust resulting from a mandatory division or severance described in this paragraph will have the same inclusion ratio immediately after the severance as that of the orig-

inal trust immediately before the division or severance.

* * * * *

(5) * * *

Example 8. Subsequent mandatory division into separate trusts. T creates an irrevocable trust that provides the trustee with the discretionary power to distribute income or corpus to T's children and grandchildren. The trust provides that, when T's youngest child reaches age 21, the trust will be divided into separate shares, one share for each child of T. The income from a respective child's share will be paid to the child during the child's life, with the remainder passing on the child's death to such child's children (grandchildren of T). The separate shares that come into existence when the youngest child reaches age 21 will be recognized as of that date as separate trusts for purposes of Chapter 13. The inclusion ratio of the separate trusts will be identical to the inclusion ratio of the trust before the severance. Any allocation of GST tax exemption to the trust after T's youngest child reaches age 21 may be made to any one or more of the separate shares. The result would be the same if the trust instrument provided that the trust was to be divided into separate trusts when T's youngest child reached age 21, provided that the severance and funding of the separate trusts meets the requirements of this section.

* * * * *

(d) *Effective date.* Paragraph (a)(1)(i), paragraph (a)(1)(iii), and *Example 8* of paragraph (a)(5) apply to severances occurring on or after September 2, 2008.

* * * * *

Sherri L. Brown,
(Acting) Deputy Commissioner for
Services and Enforcement.

Approved July 20, 2008.

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

(Filed by the Office of the Federal Register on July 30, 2008, 8:45 a.m., and published in the issue of the Federal Register for July 31, 2008, 73 F.R. 44649)

Section 6621.—Determination of Rate of Interest

26 CFR 301.6621-1: Interest rate.

Interest rates; underpayments and overpayments. The rates of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 2008, will be 6 percent for overpayments (5 percent in the case of a corporation), 6 percent for underpayments, and 8 percent for large corporate underpayments. The rate of interest paid on the portion of a

corporate overpayment exceeding \$10,000 will be 3.5 percent.

Rev. Rul. 2008-47

Section 6621 of the Internal Revenue Code establishes the rates for interest on tax overpayments and tax underpayments. Under section 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 3 percentage points (2 percentage points in the case of a corporation), except the rate for the portion of a corporate overpayment of tax exceeding \$10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

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

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

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

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

pursuant to section 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of July 2008 is 3 percent. Accordingly, an overpayment rate of 6 percent (5 percent in the case of a corporation) and an underpayment rate of 6 percent are established for the calendar quarter beginning October 1, 2008. The overpayment rate for the portion of a corporate overpayment exceeding \$10,000 for the calendar quarter beginning October 1, 2008, is 3.5 percent. The un-

derpayment rate for large corporate underpayments for the calendar quarter beginning October 1, 2008, is 8 percent. These rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 3.5 percent, 5 percent, 6 percent, and 8 percent are published in Tables 12, 63, 65, and 69 of Rev. Proc. 95-17, 1995-1 C.B. 556, 566, 617, 619, and 623.

Annual interest rates to be compounded daily pursuant to section 6622 that apply

for prior periods are set forth in the tables accompanying this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Deborah Colbert-James of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue ruling, contact Ms. Colbert-James at (202) 622-8143 (not a toll-free call).

TABLE OF INTEREST RATES
PERIODS BEFORE JUL. 1, 1975 — PERIODS ENDING DEC. 31, 1986
OVERPAYMENTS AND UNDERPAYMENTS

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

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 — DEC. 31, 1998

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 — DEC. 31, 1998 – Continued

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

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

	1995-1 C.B.		
	RATE	TABLE	PG
Jan. 1, 1999—Mar. 31, 1999	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	7%	19	573

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

	RATE	1995-1 C.B.	
		TABLE	PG
Oct. 1, 2001—Dec. 31, 2001	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	6%	17	571
Jul. 1, 2005—Sep. 30, 2005	6%	17	571
Oct. 1, 2005—Dec. 31, 2005	7%	19	573
Jan. 1, 2006—Mar. 31, 2006	7%	19	573
Apr. 1, 2006—Jun. 30, 2006	7%	19	573
Jul. 1, 2006—Sep. 30, 2006	8%	21	575
Oct. 1, 2006—Dec. 31, 2006	8%	21	575
Jan. 1, 2007—Mar. 31, 2007	8%	21	575
Apr. 1, 2007—Jun. 30, 2007	8%	21	575
Jul. 1, 2007—Sep. 30, 2007	8%	21	575
Oct. 1, 2007—Dec. 31, 2007	8%	21	575
Jan. 1, 2008—Mar. 31, 2008	7%	67	621
Apr. 1, 2008—Jun. 30, 2008	6%	65	619
Jul. 1, 2008—Sep. 30, 2008	5%	63	617
Oct. 1, 2008—Dec. 31, 2008	6%	65	619

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

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

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

	OVERPAYMENTS			UNDERPAYMENTS		
	1995-1 C.B.			1995-1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PG
Oct. 1, 2002—Dec. 31, 2002	5%	15	569	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	4%	13	567	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	4%	13	567	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	4%	13	567	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	3%	11	565	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	3%	59	613	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	4%	61	615	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	3%	59	613	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	4%	61	615	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	4%	13	567	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	5%	15	569	6%	17	571
Jul. 1, 2005—Sep. 30, 2005	5%	15	569	6%	17	571
Oct. 1, 2005—Dec. 31, 2005	6%	17	571	7%	19	573
Jan. 1, 2006—Mar. 31, 2006	6%	17	571	7%	19	573
Apr. 1, 2006—Jun. 30, 2006	6%	17	571	7%	19	573
Jul. 1, 2006—Sep. 30, 2006	7%	19	573	8%	21	575
Oct. 1, 2006—Dec. 31, 2006	7%	19	573	8%	21	575
Jan. 1, 2007—Mar. 31, 2007	7%	19	573	8%	21	575
Apr. 1, 2007—Jun. 30, 2007	7%	19	573	8%	21	575
Jul. 1, 2007—Sep. 30, 2007	7%	19	573	8%	21	575
Oct. 1, 2007—Dec. 31, 2007	7%	19	573	8%	21	575
Jan. 1, 2008—Mar. 31, 2008	6%	65	619	7%	67	621
Apr. 1, 2008—Jun. 30, 2008	5%	63	617	6%	65	619
Jul. 1, 2008—Sep. 30, 2008	4%	61	615	5%	63	617
Oct. 1, 2008—Dec. 31, 2008	5%	63	617	6%	65	619

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 — PRESENT

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

**TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 — PRESENT — Continued**

	RATE	1995-1 C.B. TABLE	PG
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581
Jan. 1, 1998—Mar. 31, 1998	11%	27	581
Apr. 1, 1998—Jun. 30, 1998	10%	25	579
Jul. 1, 1998—Sep. 30, 1998	10%	25	579
Oct. 1, 1998—Dec. 31, 1998	10%	25	579
Jan. 1, 1999—Mar. 31, 1999	9%	23	577
Apr. 1, 1999—Jun. 30, 1999	10%	25	579
Jul. 1, 1999—Sep. 30, 1999	10%	25	579
Oct. 1, 1999—Dec. 31, 1999	10%	25	579
Jan. 1, 2000—Mar. 31, 2000	10%	73	627
Apr. 1, 2000—Jun. 30, 2000	11%	75	629
Jul. 1, 2000—Sep. 30, 2000	11%	75	629
Oct. 1, 2000—Dec. 31, 2000	11%	75	629
Jan. 1, 2001—Mar. 31, 2001	11%	27	581
Apr. 1, 2001—Jun. 30, 2001	10%	25	579
Jul. 1, 2001—Sep. 30, 2001	9%	23	577
Oct. 1, 2001—Dec. 31, 2001	9%	23	577
Jan. 1, 2002—Mar. 31, 2002	8%	21	575
Apr. 1, 2002—Jun. 30, 2002	8%	21	575
Jul. 1, 2002—Sep. 30, 2002	8%	21	575
Oct. 1, 2002—Dec. 31, 2002	8%	21	575
Jan. 1, 2003—Mar. 31, 2003	7%	19	573
Apr. 1, 2003—Jun. 30, 2003	7%	19	573
Jul. 1, 2003—Sep. 30, 2003	7%	19	573
Oct. 1, 2003—Dec. 31, 2003	6%	17	571
Jan. 1, 2004—Mar. 31, 2004	6%	65	619
Apr. 1, 2004—Jun. 30, 2004	7%	67	621
Jul. 1, 2004—Sep. 30, 2004	6%	65	619
Oct. 1, 2004—Dec. 31, 2004	7%	67	621
Jan. 1, 2005—Mar. 31, 2005	7%	19	573
Apr. 1, 2005—Jun. 30, 2005	8%	21	575
Jul. 1, 2005—Sep. 30, 2005	8%	21	575
Oct. 1, 2005—Dec. 31, 2005	9%	23	577
Jan. 1, 2006—Mar. 31, 2006	9%	23	577
Apr. 1, 2006—Jun. 30, 2006	9%	23	577
Jul. 1, 2006—Sep. 30, 2006	10%	25	579
Oct. 1, 2006—Dec. 31, 2006	10%	25	579
Jan. 1, 2007—Mar. 31, 2007	10%	25	579
Apr. 1, 2007—Jun. 30, 2007	10%	25	579
Jul. 1, 2007—Sep. 30, 2007	10%	25	579
Oct. 1, 2007—Dec. 31, 2007	10%	25	579
Jan. 1, 2008—Mar. 31, 2008	9%	71	625
Apr. 1, 2008—Jun. 30, 2008	8%	69	623
Jul. 1, 2008—Sep. 30, 2008	7%	67	621
Oct. 1, 2008—Dec. 31, 2008	8%	69	623

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING \$10,000
FROM JANUARY 1, 1995 — PRESENT

	RATE	1995-1 C.B. TABLE	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572
Jan. 1, 1998—Mar. 31, 1998	6.5%	18	572
Apr. 1, 1998—Jun. 30, 1998	5.5%	16	570
Jul. 1, 1998—Sep. 30, 1998	5.5%	16	570
Oct. 1, 1998—Dec. 31, 1998	5.5%	16	570
Jan. 1, 1999—Mar. 31, 1999	4.5%	14	568
Apr. 1, 1999—Jun. 30, 1999	5.5%	16	570
Jul. 1, 1999—Sep. 30, 1999	5.5%	16	570
Oct. 1, 1999—Dec. 31, 1999	5.5%	16	570
Jan. 1, 2000—Mar. 31, 2000	5.5%	64	618
Apr. 1, 2000—Jun. 30, 2000	6.5%	66	620
Jul. 1, 2000—Sep. 30, 2000	6.5%	66	620
Oct. 1, 2000—Dec. 31, 2000	6.5%	66	620
Jan. 1, 2001—Mar. 31, 2001	6.5%	18	572
Apr. 1, 2001—Jun. 30, 2001	5.5%	16	570
Jul. 1, 2001—Sep. 30, 2001	4.5%	14	568
Oct. 1, 2001—Dec. 31, 2001	4.5%	14	568
Jan. 1, 2002—Mar. 31, 2002	3.5%	12	566
Apr. 1, 2002—Jun. 30, 2002	3.5%	12	566
Jul. 1, 2002—Sep. 30, 2002	3.5%	12	566
Oct. 1, 2002—Dec. 31, 2002	3.5%	12	566
Jan. 1, 2003—Mar. 31, 2003	2.5%	10	564
Apr. 1, 2003—Jun. 30, 2003	2.5%	10	564
Jul. 1, 2003—Sep. 30, 2003	2.5%	10	564
Oct. 1, 2003—Dec. 31, 2003	1.5%	8	562
Jan. 1, 2004—Mar. 31, 2004	1.5%	56	610
Apr. 1, 2004—Jun. 30, 2004	2.5%	58	612
Jul. 1, 2004—Sep. 30, 2004	1.5%	56	610
Oct. 1, 2004—Dec. 31, 2004	2.5%	58	612
Jan. 1, 2005—Mar. 31, 2005	2.5%	10	564
Apr. 1, 2005—Jun. 30, 2005	3.5%	12	566
Jul. 1, 2005—Sep. 30, 2005	3.5%	12	566
Oct. 1, 2005—Dec. 31, 2005	4.5%	14	568
Jan. 1, 2006—Mar. 31, 2006	4.5%	14	568
Apr. 1, 2006—Jun. 30, 2006	4.5%	14	568
Jul. 1, 2006—Sep. 30, 2006	5.5%	16	570
Oct. 1, 2006—Dec. 31, 2006	5.5%	16	570
Jan. 1, 2007—Mar. 31, 2007	5.5%	16	570
Apr. 1, 2007—Jun. 30, 2007	5.5%	16	570
Jul. 1, 2007—Sep. 30, 2007	5.5%	16	570
Oct. 1, 2007—Dec. 31, 2007	5.5%	16	570

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING \$10,000
FROM JANUARY 1, 1995 — PRESENT — Continued

	RATE	1995-1 C.B. TABLE	PG
Jan. 1, 2008—Mar. 31, 2008	4.5%	62	616
Apr. 1, 2008—Jun. 30, 2008	3.5%	60	614
Jul. 1, 2008—Sep. 30, 2008	2.5%	58	612
Oct. 1, 2008—Dec. 31, 2008	3.5%	12	566

Part III. Administrative, Procedural, and Miscellaneous

Application of Section 382 in the Case of Certain Acquisitions Made Pursuant to the Housing and Economic Recovery Act of 2008

Notice 2008-76

SECTION 1. OVERVIEW

This notice announces that the Internal Revenue Service (IRS) and the Treasury Department (Treasury) will issue regulations under section 382(m) of the Internal Revenue Code (Code) that address the application of section 382 in the case of certain acquisitions made pursuant to the Housing and Economic Recovery Act of 2008.

Pursuant to section 1117(a) and (b) of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (2008), the Secretary of the Treasury is authorized to purchase any obligations and other securities issued by certain entities under the Housing and Economic Recovery Act of 2008. A purchase that is made pursuant to this authority is hereinafter referred to as a "Housing Act Acquisition."

SECTION 2. REGULATIONS TO BE ISSUED UNDER SECTION 382(m)

The IRS and Treasury will issue regulations under section 382(m) providing that notwithstanding any other provision of the Code or the regulations thereunder, for purposes of section 382 and the regulations thereunder, with respect to a corporation as to which there is a Housing Act Acquisition, the term "testing date" (as defined in § 1.382-2(a)(4)) shall not include any date on or after the date on which the United States (or any agency or instrumentality thereof) (United States) acquires, in a Housing Act Acquisition, stock (including stock described in section 1504(a)(4)) or an option to acquire stock in the corporation.

SECTION 3. EFFECTIVE DATE

The regulations to be issued under section 382(m) that are described in section 2 of this notice will apply on or after Septem-

ber 7, 2008, and will apply unless and until there is additional guidance.

26 CFR 601.201: Rulings and determination letters. (Also Part I. Sections 103(c), 105(e), 117(b)(2)(A), 164, 170, 403(b)(1)(A)(ii), 454(b)(2), 511(a)(2)(B), 2055, 2106(a)(2), 2522, 4041(g), 4216, 4253(i), 4483(a), 4911, 4940(c), 4941(d), 4942(f), 4945(f), 4946(c).)

Rev. Proc. 2008-55

SECTION 1. GENERAL

.01 PURPOSE

The purpose of this revenue procedure is to designate the Indian tribal entities that appear on the current or future lists of federally recognized Indian tribes published annually by the Department of the Interior, Bureau of Indian Affairs, as Indian tribal governments for purposes of section 7701(a)(40). Indian tribal governments are treated as States for certain purposes under section 7871(a).

.02 BACKGROUND

(1) Internal Revenue Code and Treasury Regulations. The Indian Tribal Governmental Tax Status Act of 1982 (Title II of Pub. L. No. 97-473, 1983-1 C.B. 510, 511, as amended by Pub. L. No. 98-21, 1983-2 C.B. 309, 315) added sections 7701(a)(40) and 7871 to the Code. Section 7871(a) provides that Indian tribal governments (or subdivisions thereof) will be treated as states for certain enumerated federal tax purposes. For example, charitable contributions to or for the use of a tribal government may be deductible under the federal income, gift, and estate tax laws; a tribal government is entitled to exemption from certain excise taxes; taxes imposed by a tribe may be deductible; and public activity bonds may be tax exempt obligations. §§ 7871(a)(1), (a)(3), (a)(4). As originally enacted in 1982, the provisions of section 7871 were temporary. These provisions were made permanent by section 1065 of the Tax Reform Act of 1984, Pub. L. 98-369, 1984-3 (Vol. 1) C.B. 556. Section 7701(a)(40) defines the term Indian tribal government to mean the governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, which is deter-

mined by the Secretary, after consultation with the Secretary of the Interior, to exercise governmental functions.

Temporary Regulation section 305.7701-1(a) provides that a governing body of a tribe, band, pueblo, community, village, or group of native American Indians, or Alaska Natives, qualifies as an Indian tribal government upon determination by the Internal Revenue Service that the governing body exercises governmental functions. Designation of a governing body as an Indian tribal government will be by revenue procedure. The temporary regulation further provides that if a governing body is not currently designated by revenue procedure as an Indian tribal government, and such governing body believes that it qualifies for such designation, the governing body may apply for a ruling from the Internal Revenue Service.

(2) Federally Recognized Indian Tribe List Act and Associated Regulations. Under the Federally Recognized Indian Tribe List Act of 1994, Pub. L. 103-454, 108 Stat. 4791 ("List Act"), the Secretary of the Interior is required to publish annually a list of all federally recognized Indian tribes. The list must reflect all of the tribes that the Secretary of the Interior recognizes to be eligible for the programs and services provided by the United States to Indians because of their status as Indians. 25 USC § 479a-1(b). The United States has a government-to-government relationship with and recognizes the sovereignty of recognized Indian tribes. List Act § 103(2). The Secretary of the Interior recognizes the entities on the list as Indian tribes with a government-to-government relationship with the United States. See 44 Fed. Reg. 7,235 (Feb. 6, 1979); 58 Fed. Reg. 54,364 (Oct. 21, 1993); and 60 Fed. Reg. 9,250 (Feb. 16, 1995). The government-to-government relationship of a tribe that is on this list may not be terminated except by an Act of Congress. List Act § 103(4).

The Department of the Interior publishes its list annually in the Federal Register. The most recent list was published in 73 Fed. Reg. 18,553 (April 4, 2008).

(3) Previous Revenue Procedures. The Internal Revenue Service has issued three

revenue procedures listing Indian tribal entities recognized as Indian tribal governments for purposes of section 7701(a)(40). *See* Rev. Proc. 83-87, 1983-2 C.B. 606; Rev. Proc. 2001-15, 2001-1 C.B. 465; Rev. Proc. 2002-64, 2002-2 C.B. 717. For each of the 2001 and 2002 revenue procedures, the Indian tribal entities listed were also the Indian tribes on the most recent annual list published by the Department of the Interior pursuant to the List Act.

SECTION 2. APPLICATION

.01 In general, an Indian tribal entity that appears on the most recent list published by the Department of the Interior in the Federal Register pursuant to the requirements of the List Act is designated an Indian tribal government for purposes of section 7701(a)(40). Tribal entities not appearing on the list that believe they qualify to be recognized as Indian tribes may contact the Office of Federal Acknowledgment in the Department of the Interior for information on how to apply for recogni-

tion pursuant to Department of the Interior procedures. Tribal entities not appearing on the list may apply for a ruling on whether they qualify as Indian tribal governments under section 7701(a)(40) pursuant to all applicable rules set forth in the Statement of Procedural Rules (26 CFR Part 601), and guidelines set forth in Rev. Proc. 84-37, 1984-1 C.B. 513, as modified by Rev. Proc. 86-17, 1986-1 C.B. 550, and Rev. Proc. 2008-1, 2008-1 I.R.B. 1.

.02 A tribe that does not appear on the most recent list published by the Department of the Interior in the Federal Register pursuant to the requirements of the List Act will nonetheless be treated as an Indian tribal government for purposes of section 7701(a)(40) if the tribe has been acknowledged as a federally recognized Indian tribe, as stated in a letter from the Department of the Interior.

.03 Qualification as an Indian tribal government does not necessarily establish that a tribe qualifies for a particular tax benefit. For example, when a tribal entity seeks exemption from excise taxes,

the entity must be able to demonstrate that the underlying transaction involves the exercise of an essential governmental function of the Indian tribal government. § 7871(b).

SECTION 3. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-64 is superseded.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective on the date of publication.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is Carol Cook of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue procedure, contact Ms. Cook at (202) 622-1124 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Rules for Home Construction Contracts

REG-120844-07

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations amending the regulations under §1.460 to provide guidance to taxpayers in the home construction industry regarding accounting for certain long-term construction contracts that qualify as home construction contracts under section 460(e)(6) of the Internal Revenue Code (Code) and to provide guidance to taxpayers with long-term contracts under section 460(f) regarding certain changes in method of accounting for long-term contracts. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by November 3, 2008. Outlines of topics to be discussed at the public hearing scheduled for December 5, 2008, at 10:00 a.m. must be received by November 13, 2008.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-120844-07), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20224. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-120844-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-120844-07). The public hearing will be held in the auditorium, Internal Revenue Service Building, 1111

Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Brendan P. O'Hara, (202) 622-4920; concerning submission of comments, the hearing, or to be placed on the building access list to attend the hearing, Richard Hurst, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains a proposed amendment to the Income Tax Regulations, 26 CFR Part 1, under section 460 and §§1.460-3, 1.460-4, 1.460-5 and 1.460-6 of the Income Tax Regulations. In general, section 460(a) requires taxpayers to use the percentage of completion method (PCM) to account for taxable income from any long-term contract. Section 460(e) exempts home construction contracts from the general requirement to use the percentage of completion method of accounting. Section 460(e)(6) defines a home construction contract to be any construction contract if 80 percent or more of the total estimated contract costs are reasonably expected to be attributable to the construction of (i) dwelling units contained in buildings containing 4 or fewer dwelling units, and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units. Section 460(e)(4) defines a construction contract to be any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvement of, real property.

These proposed regulations expand the types of contracts eligible for the home construction contract exemption and amend the rules for how taxpayer-initiated changes in methods of accounting to comply with the regulations under section 460 may be implemented.

Definition of a Home Construction Contract

Improvements to real property

The definition of a *construction contract* under section 460(e) includes many transactions involving land developers and construction service providers in the home construction industry. For example, a construction contract under section 460(e) includes a contract for the provision of land by the taxpayer if the estimated total allocable contract costs attributable to the taxpayer's construction activities (not including the cost of the land provided to the customer) are 10 percent or more of the contract's total contract price.

As noted, section 460(a) requires that the income from any long-term contract be recognized using the percentage of completion method. However, taxpayers with contracts that meet the definition of a "home construction contract" are not required to use the percentage of completion method for those contracts and may use an exempt method. Exempt methods commonly used to account for home construction contracts include the completed contract method (CCM) and the accrual method.

Under section 460, a home construction contract includes any construction contract if 80 percent of the total estimated contract costs are reasonably expected to be attributable to the construction of improvements to real property directly related to qualifying dwelling units and located on the site of such dwelling units. Commentators have suggested that many contracts entered into by land developers in the home construction industry should fall within the definition of a home construction contract.

The proposed regulations expand the scope of the home construction contract exemption by providing that a contract for the construction of common improvements is considered a contract for the construction of improvements to real property directly related to the dwelling unit(s) and located on the site of such dwelling unit(s), even if the contract is not for the construction of any dwelling unit. Therefore, under the proposed regulations, a land developer that is selling individual lots (and its contractors and subcontractors) may

have long-term construction contracts that qualify for the home construction contract exemption.

Townhouses, rowhouses, and condominiums

Under section 460, a home construction contract also includes any construction contract if 80 percent of the total contract costs are reasonably expected to be attributable to the construction of dwelling units contained in buildings containing four or fewer dwelling units. Section 460(e)(6) states that each townhouse or rowhouse shall be treated as a separate building, regardless of the number of townhouses or rowhouses physically attached to each other. In certain circumstances, the terms condominium and townhouse are used interchangeably to describe similar structures. Individual condominium units possess many of the characteristics generally associated with townhouses and rowhouses such as private ownership, shared portions of their structures, residential housing, and the economics of the underlying purchase transactions.

The proposed regulations expand what is considered a townhouse or rowhouse, for purposes of the home construction contract exemption, to include an individual condominium unit. This will have the effect of allowing each condominium unit to be treated as a separate building for purposes of determining whether the underlying contract qualifies as a home construction contract.

Completed contract method

Under the current regulations under section 460, the appropriate severing of a home construction contract requires a facts and circumstances analysis based upon certain factors that are neither specific nor always relevant to home construction contracts. Likewise, the date a home construction contract is considered completed and accepted is determined using a facts and circumstances analysis.

The IRS and Treasury Department are aware of controversies related to the application of the existing facts and circumstances analyses for determining the appropriate severance and final completion and acceptance of home construction contracts accounted for using the completed contract method. Expanding the

definition of a home construction contract as provided in these proposed regulations may heighten the significance of these issues. As a result, the IRS and Treasury Department expect to propose specific severing and completion rules for home construction contracts accounted for using the completed contract method. Taxpayers are encouraged to submit comments on the types of severing and completion rules that would result in the clear reflection of income for home construction contracts accounted for using the completed contract method. Specifically, the IRS and the Treasury Department request comments on the circumstances (if any) in which it would not be appropriate to require severing and completion of a home construction contract to be determined on a dwelling unit by dwelling unit or lot by lot basis or, when a contract is not for the sale of a dwelling unit or lot, on the basis of when the taxpayer receives payment(s) under the contract.

Method of accounting

Currently, the regulations under section 460 provide that a taxpayer that uses the percentage-of-completion method (PCM), the exempt-contract percentage-of-completion method (EPCM), or elects the 10-percent method or special alternative minimum taxable income (AMTI) method, or that adopts or elects a cost allocation method of accounting (or changes to another method of accounting with the Commissioner's consent) must apply the method(s) consistently for all similarly classified contracts until the taxpayer obtains the Commissioner's consent under section 446 to change to another method of accounting. The regulations further provide that a taxpayer-initiated change in method of accounting will be permitted only on a cut-off basis (that is, for contracts entered into on or after the year of change), and thus, a section 481(a) adjustment will not be permitted nor required. The proposed regulations continue this cut-off method of implementation but only for taxpayer-initiated changes from a permissible PCM method to another permissible PCM method for long-term contracts for which PCM is required and for taxpayer-initiated changes from a cost allocation method of accounting that complies with the cost allocation

rules of §1.460-5 to another cost allocation method of accounting that complies with the cost allocation rules of §1.460-5. Under the proposed regulations all other taxpayer-initiated changes in method of accounting under section 460 will be made with a section 481(a) adjustment.

The proposed regulations provide that in determining the hypothetical underpayment or overpayment of tax for any year as part of the look-back computation, amounts reported as section 481(a) adjustments shall generally be taken into account in the tax year or years they are reported. For purposes of determining whether there is a hypothetical underpayment or overpayment of tax under the look-back computation, a taxpayer would use amounts reported under its old method for the years the old method was used and would use amounts reported under its new method for the years the new method was used, netted against the amount of any section 481(a) adjustments required to be taken into account. Thus, a look-back computation would not be required upon contract completion simply because the taxpayer has changed its method of accounting. However, a look-back computation would be required upon contract completion if actual costs or the contract price differ from the estimated amounts notwithstanding the fact a change in method of accounting occurred. For example, if a taxpayer using PCM changed its method of accounting for construction costs incurred in a contract reported under PCM, the section 460 look-back would be computed using the costs recognized prior to the year of change (reported under the taxpayer's old method of accounting) and the costs recognized in subsequent years using the new method of accounting, netted against any applicable section 481(a) adjustment. Similarly, for changes in methods of accounting where no costs were recognized under the old method of accounting (for example, a change in method of accounting from CCM to PCM), look-back would effectively only apply to years in which the taxpayer's new method of accounting was used to the extent that no costs were recognized prior to the year of change under the old method of accounting. This approach to the look-back computation is consistent with the underlying purpose of look-back as well as the general accounting method

change procedures. Comments are specifically requested with respect to issues that taxpayers may foresee with respect to the rules provided in these proposed regulations for taking into account section 481(a) adjustments in the year reported for purposes of the look-back computation.

Proposed Effective/Applicability Date

These regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. The final regulations will provide rules applicable to taxpayers that seek to change a method of accounting to comply with the rules contained in the final regulations. Taxpayers may not change or otherwise use a method of accounting in reliance upon the rules contained in these new proposed regulations until the rules are published as final regulations in the **Federal Register**.

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for December 5, 2008, beginning

at 10:00 a.m., in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 13, 2008. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.460-3 is amended by:

1. Revising paragraph (b)(1)(ii).
2. Redesignating paragraphs (b)(2)(ii), (b)(2)(iii) and (b)(2)(iv) as paragraphs (b)(2)(iii), (b)(2)(iv) and (b)(2)(v), respectively, and revising them.
3. Adding a new paragraph (b)(2)(ii).

The revisions and addition read as follows:

§1.460-3 Long-term construction contracts.

* * * * *

(b) * * *

(1) * * *

(ii) Construction contract, other than a home construction contract, that a taxpayer estimates (when entering into the contract) will be completed within 2 years of the contract commencement date, provided the taxpayer satisfies the \$10,000,000 gross receipts test described in paragraph (b)(3) of this section.

(2) * * *

(ii) *Land improvements*. For purposes of paragraph (b)(2)(i)(B) of this section, improvements to real property directly related to, and located on the site of, the dwelling units consist of improvements to land on which dwelling units (as described in paragraph (b)(2)(i)(A) of this section) are constructed, and common improvements as defined in paragraph (b)(2)(iv) of this section. A long-term construction contract is a home construction contract if a taxpayer (including a subcontractor working for a general contractor) meets the 80% test in paragraph (b)(2)(i) of this section as applied to either paragraph (b)(2)(i)(A) of this section or paragraph (b)(2)(i)(B) of this section, or both paragraphs (b)(2)(i)(A) and (b)(2)(i)(B) of this section, collectively.

(iii) *Townhouses and rowhouses*. For purposes of determining whether a long-term construction contract is a home construction contract under paragraph (b)(2) of this section, each townhouse or rowhouse is a separate building. For this purpose, the term townhouse and rowhouse includes an individual condominium unit.

(iv) *Common improvements—(A) In general*. A taxpayer includes in the cost of a dwelling unit or land its allocable share of the cost that the taxpayer incurs for any common improvements that benefit the dwelling unit or land.

(B) *Definition*. For purposes of this section, a *common improvement* is an improvement that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land containing the dwelling units (or the land on which dwelling units are to be constructed)

and that benefits the dwelling units (or the land on which dwelling units are to be constructed). In general, a common improvement does not solely benefit any particular dwelling unit or any particular lot on which a dwelling unit is constructed. However, land clearing and grading are common improvements, even when performed on a particular lot. Other examples of common improvements are sidewalks, sewers, roads and clubhouses.

(v) *Mixed use costs.* If a contract involves the construction of both commercial units and dwelling units, a taxpayer must allocate the costs among the commercial units and dwelling units using a reasonable method or combination of reasonable methods. In general, the reasonableness of an allocation method will be based on facts and circumstances. Examples of methods that may be reasonable are specific identification, square footage, or fair market value.

Par. 3. Section 1.460-4 is amended by:

1. Revising the third sentence in paragraph (c)(1).
2. Redesignating paragraph (g) as paragraph (g)(1) and revising newly redesignated paragraph (g)(1).
3. Adding a paragraph (g)(2).
4. Revising *Example 5.* of paragraph (h).

The revisions and additions read as follows:

§1.460-4 Methods of accounting for long-term contracts.

(c) ***

(1) *** Permissible exempt contract methods are the PCM, the EPCM described in paragraph (c)(2) of this section, the CCM described in paragraph (d) of this section, the accrual method, and any other permissible method. ***

(g) *Method of accounting—(1) In general.* A taxpayer must apply its method(s) of accounting for long-term contracts consistently for all similarly classified long-term contracts until the taxpayer obtains the Commissioner's consent under section 446(e) to change to another method of accounting.

(2) *Taxpayer-initiated change in method of accounting—(i) Change to PCM for long-term contracts for which PCM is required.* A taxpayer-initiated change in method of accounting for long-term contracts (or portion thereof) for which income must be determined using the PCM described in paragraph (b) of this section and the costs allocation rules described in §1.460-5(b) or (c) (required PCM contracts) from a method of accounting that does not comply with paragraph (b) of this section and §1.460-5(b) or (c) to a method that complies with paragraph (b) of this section and §1.460-5(b) or (c) must be applied to all required PCM contracts entered into before the year of change and not reported as completed as of the beginning of the year of change. Accordingly, a section 481(a) adjustment will be required.

(ii) *Change from a permissible PCM method to another permissible PCM method for long-term contracts for which PCM is required.* A taxpayer initiated change in method of accounting for required PCM contracts, as defined in paragraph (g)(2)(i) of this section (or a portion thereof), from a method of accounting that complies with paragraph (b) of this section and §1.460-5(b) or (c) to another method of accounting that complies with paragraph (b) of this section and §1.460-5(b) or (c) must be made on a cut-off basis and applied only to contracts entered into during and after the year of change. Accordingly, a section 481(a) adjustment will be neither permitted nor required.

(iii) *Change to an exempt contract method for home construction contracts.* A taxpayer-initiated change in method of accounting for home construction contracts, as defined in §1.460-3(b)(2), to a permissible exempt contract method, as described in paragraph (c)(1) of this section, must be applied to all home construction contracts entered into before the year of change and not reported as completed as of the beginning of the year of change. Accordingly, a section 481(a) adjustment will be required.

(iv) *Change to an exempt contract method for exempt contracts other than home construction contracts.* A taxpayer-initiated change in method of accounting for long-term contracts (or portion thereof) not described in paragraphs (g)(2)(i), (ii) and (iii) of this section to a

permissible exempt contract method as described in paragraph (c)(1) of this section must be applied to all contracts that are eligible to use the exempt contract method entered into before the year of change and not reported as completed as of the beginning of the year of change. Accordingly, a section 481(a) adjustment will be required.

(h) ***

Example 5. PCM—contract terminated. C, whose taxable year ends December 31, determines the income from long-term contracts using the PCM. During 2001, C buys land and begins constructing a building that will contain 50 apartment units on that land. C enters into a contract to sell the building to B for \$2,400,000. B gives C a \$50,000 deposit toward the purchase price. By the end of 2001, C has incurred \$500,000 of allocable contract costs on the building and estimates that the total allocable contract costs on the building will be \$1,500,000. Thus, for 2001, C reports gross receipts of \$800,000 (\$500,000 / \$1,500,000 x \$2,400,000), current-year costs of \$500,000, and gross income of \$300,000 (\$800,000 - \$500,000). In 2002, after C has incurred an additional \$250,000 of allocable contract costs on the building, B files for bankruptcy protection and defaults on the contract with C, who is permitted to keep B's \$50,000 deposit as liquidated damages. In 2002, C reverses the transaction with B under paragraph (b)(7) of this section and reports a loss of \$300,000 (\$500,000 - \$800,000). In addition, C obtains an adjusted basis in the building sold to B of \$700,000 (\$500,000 (current-year costs deducted in 2001) - \$50,000 (B's forfeited deposit) + \$250,000 (current-year costs incurred in 2002)). C may not apply the look-back method to this contract in 2002.

Par. 4. Section 1.460-5 is amended by:

1. Adding a new sentence to the end of paragraph (c)(2).
2. Revising paragraph (g).

The revision and addition read as follows:

§1.460-5 Cost allocation rules.

(c) ***

(2) *** Further, this election is not available if a taxpayer is changing from a cost allocation method other than as prescribed in paragraph (b) of this section, in which case the taxpayer must follow the procedures under §1.446-1(e) for obtaining the Commissioner's consent for the change in method of accounting.

(g) *Method of accounting.* A taxpayer that adopts, elects, or otherwise changes

to a cost allocation method of accounting (or changes to another cost allocation method of accounting with the Commissioner's consent) must apply that method consistently for all similarly classified contracts, until the taxpayer obtains the Commissioner's consent under section 446 to change to another cost allocation method. A taxpayer-initiated change in cost allocation method from a method that does not comply with the cost allocation rules of this section to a method that complies with the cost allocation rules of this section must be applied to all long-term contracts to which the rules of this section apply, including contracts entered into before the year of change and not reported as completed as of the beginning of the year of change. Accordingly, a section 481(a) adjustment is required. Any other taxpayer-initiated change in cost allocation method to a method permitted under the rules of this section must be made on a cut-off basis and applied only to contracts entered into during and after the year of change, in which case a section 481(a) adjustment will be neither permitted nor required.

Par. 5. Section 1.460-6 is amended by:

1. Adding paragraph (c)(3)(vii).

2. Redesignating paragraph (d)(2)(iv) as paragraph (d)(2)(v).

3. Adding a new paragraph (d)(2)(iv).

The additions and revision read as follows:

§1.460-6 Look-back method.

* * * * *

(c) * * *

(3) * * *

(vii) *Section 481(a) adjustments.* For purposes of determining the hypothetical underpayment or overpayment of tax for any year, amounts reported as section 481(a) adjustments shall be taken into account in the tax year or years they are reported. However, any portion of a section 481(a) adjustment not yet reported as of the tax year in which the contract is completed shall be taken into account in the tax year the contract is completed for purposes of determining the hypothetical underpayment or overpayment of tax.

* * * * *

(d) * * *

(2) * * *

(iv) *Section 481(a) adjustments.* For purposes of determining the hypothetical underpayment or overpayment of tax for any year under the simplified marginal impact method, amounts reported as section 481(a) adjustments shall be taken into account in the tax year or years they are reported. However, any portion of a section 481(a) adjustment not yet reported as of the tax year in which the contract is completed shall be taken into account in the tax year the contract is completed for purposes of determining the hypothetical underpayment or overpayment of tax.

* * * * *

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

(Filed by the Office of the Federal Register on August 1, 2008, 8:45 a.m., and published in the issue of the Federal Register for August 4, 2008, 73 F.R. 45180)

Notice of Proposed Rulemaking

Employee Stock Purchase Plans Under Internal Revenue Code Section 423

REG-106251-08

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to options granted under an employee stock purchase plan as defined in section 423 of the Internal Revenue Code (Code). These proposed regulations affect certain taxpayers who participate in the transfer of stock pursuant to the exercise of options granted under an employee stock purchase plan. These proposed regulations provide guidance to assist taxpayers in complying with section 423 in addition to clarifying certain rules regarding options granted under an employee stock purchase plan. This document also contains proposed regulations under sections 421 and 422 of the Code.

DATES: Written or electronic comments must be received by October 27, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-106251-08), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-106251-08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at <http://www.regulations.gov/> (IRS REG-106251-08).

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, Thomas Scholz at (202) 622-6030; concerning submissions of comments, and/or to request a hearing, Oluwafunmilayo Taylor, at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 423 of the Code. This document also contains minor proposed amendments to 26 CFR part 1 under sections 421 and 422 of the Code.

Section 423 was added to the Code by section 221(a) of the Revenue Act of 1964, Public Law 88-272 (78 Stat. 63 (1964)). Changes to the applicable law concerning section 423 were made by sections 1402(b)(1)(C) and 1402(b)(2) of the Tax Reform Act of 1976, Public Law 94-455 (90 Stat. 1731 and 1732-1733 (1976)); section 1001(b)(5) of the Deficit Reduction Act of 1984, Public Law 98-369 (98 Stat. 1011 (1984)); section 1114 of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2451 (1986)); and sections 11801(c)(9)(D)(i)-(ii) and 11801(c)(9)(E) of the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508 (104 Stat. 1388-525 (1990)).

Regulations under section 423 were published in the **Federal Register** on June 23, 1966 (T.D. 6887, 1966-2 C.B. 129). These regulations were amended on September 27, 1979 (T.D. 7645, 1979-2 C.B. 198), October 31, 1980 (T.D. 7728, 1980-2 C.B. 236), and December 1, 1988 (T.D. 8235, 1989-1 C.B. 117). In Notice 2004-55, 2004-2 C.B. 319 (August 23,

2004), (see §601.601(d)(2)(ii)(b)), the IRS and the Treasury Department requested comments concerning whether the existing regulations under section 423 should be amended, and if so, what issues should be addressed. Two comment letters were submitted in response to Notice 2005-55 and the suggestions in those letters are addressed in this preamble.

In general, the income tax treatment of the grant of an option to purchase stock in connection with the performance of services and of the transfer of stock pursuant to the exercise of the option is determined under section 83 and the regulations thereunder. However, section 421 provides special rules for determining the income tax treatment of the transfer of shares of stock pursuant to the exercise of an option if the requirements of sections 422(a) or 423(a), as applicable, are met. Section 422 applies to incentive stock options and section 423 applies to options granted under an employee stock purchase plan (collectively, statutory options).

Under section 421, if a share of stock is transferred to an individual pursuant to the exercise of a statutory option, there is no income at the time of exercise of the option with respect to the transfer and no deduction under section 162 is allowed to the employer corporation with respect to the transfer.

Section 423(a) provides that section 421 applies to the transfer of stock to an individual pursuant to the exercise of an option granted under an employee stock purchase plan if: (i) no disposition of the stock is made within two years from the date of grant of the option or within one year from the date of transfer of the share, and (ii) at all times during the period beginning on the date of grant and ending on the day three months before the exercise of the option, the individual is an employee of either the corporation granting the option or a parent or subsidiary of such corporation, or a corporation (or a parent or subsidiary of such corporation) issuing or assuming a stock option in a transaction to which section 424(a) applies. Section 423(b) sets forth several requirements that must be met for a plan to qualify as an employee stock purchase plan. Section 423(c) provides a special rule that is applicable where the option exercise price is between 85 and 100 percent of the fair

market value of the stock at the time the option was granted.

Section 424 provides special rules applicable to statutory options, including rules concerning the modification of statutory options and the substitution or assumption of an option by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation. Section 424 also contains definitions of certain terms, including disposition, parent corporation, and subsidiary corporation. Finally, section 424 provides special rules related to attribution of stock ownership and the effect of stockholder approval on the date of grant of a statutory option.

Explanation of Provisions

These proposed regulations would provide a comprehensive set of rules governing stock options issued under an employee stock purchase plan and would incorporate substantially all of the rules contained in the existing regulations under section 423. These proposed regulations are comprised of two sections: Section 1.423-1, applicability of section 421(a); and §1.423-2, employee stock purchase plan defined. These proposed regulations would amend the existing regulations under section 423 in several ways. First, these proposed regulations would update the existing regulations to incorporate statutory changes and to make them consistent, where appropriate, with the regulations under section 422 related to incentive stock options. The regulations under section 422 were last updated in 2004. See T.D. 9144, 2004-2 C.B. 413. Second, these proposed regulations would update the existing regulations to provide additional guidance in certain areas as discussed below. Finally, these proposed regulations would also update the existing regulations to remove obsolete rules.

1. General requirements

Under §1.423-2(a)(1) of these proposed regulations, an employee stock purchase plan must meet the requirements of paragraphs (i) through (ix) of §1.423-2(a)(2). The terms of the plan, or an offering under the plan, must satisfy the requirements of paragraphs (iii) through (ix) of §1.423-2(a)(2). Consistent with §1.422-2(b)(1), §1.423-2(a)(1) of these

proposed regulations would provide that the plan and the terms of an offering must be in writing or electronic form, provided that such writing or electronic form is adequate to establish the terms of the plan or offering.

Section 1.423-2(a)(2) of these proposed regulations lists the requirements that must be met for qualification as an employee stock purchase plan and provides cross references to the specific section of these regulations that addresses each requirement.

Under §1.423-2(a)(3) of these proposed regulations, if the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under the plan, then the option will not be treated as granted under an employee stock purchase plan. (Section 1.423-2(a)(2) of the existing regulations has been re-numbered as §1.423-2(a)(3) of these proposed regulations.) If an option with terms that are inconsistent with the terms of the plan or an offering under the plan is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and the employee is not granted an option under the offering that qualifies as an option granted under an employee stock purchase plan, then the offering will not meet the requirements of §1.423-2(e) of these proposed regulations, which generally requires that options be granted to all employees of any corporation whose employees are granted options under an employee stock purchase plan. As a result, none of the options granted under the offering will be eligible for the special tax treatment of section 421. *Example 1* in §1.423-2(a)(4) illustrates this principle. Section 1.423-2(a)(4) of these proposed regulations contains additional examples to illustrate the principles of §1.423-2(a)(3).

If an option with terms that are inconsistent with the terms of the plan or an offering under the plan is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, then the option will not be treated as an option granted under an employee stock purchase plan, and the grant of the option will not disqualify the options granted under the offering. *Examples 2 and 3* in §1.423-2(a)(4) of these proposed regulations illustrate this principle.

If, at the time of grant, an option qualifies as an option granted under an employee stock purchase plan, but the terms of the option are not satisfied, then the option will not be treated as granted under an employee stock purchase plan. However, this failure to comply with the terms of the option will not disqualify the options granted under the plan or offering. *Example 4* in §1.423-2(a)(4) of these proposed regulations illustrates this principle.

2. Stockholder approval of the employee stock purchase plan

To qualify as an employee stock purchase plan, section 423(b)(2) requires that the plan be approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. These proposed regulations would provide the same basic requirements for stockholder approval as those included in the existing regulations. Consistent with §1.422-2(b)(2), these proposed regulations would provide additional guidance concerning the circumstances under which stockholder approval is required.

These proposed regulations, like the existing regulations, would require stockholder approval if there is a change in the aggregate number of shares or in the employees eligible to be granted options under the plan. The standard for determining when stockholder approval is required under these proposed regulations generally is the same as under the existing regulations. These proposed regulations would clarify the requirements for stockholder approval and would provide a more comprehensive list of situations that require new stockholder approval of the plan. In particular, these proposed regulations would clarify that new stockholder approval is required if there is a change in the shares with respect to which options are issued or a change in the granting corporation.

For example, assume that S, a wholly owned subsidiary of P, adopts an employee stock purchase plan under which options for S stock will be granted to S employees, and the plan is approved by the stockholder of S (in this case, P) within the applicable 24-month period. If S later amends the plan to provide for the grant of options to acquire P stock (rather than S stock), S must obtain approval from the

stockholders of S (in this case, P) within 12 months before or after the date of the amendment of the plan because the amendment of the plan to allow the grant of options for P stock is considered the adoption of a new plan. See paragraph (iii) of *Example 1* in §1.423-2(c)(5) of these proposed regulations. This conclusion differs from that in paragraph (iii) of *Example 1* under §1.422-2(b)(6), which concludes that the stockholders of P rather than the stockholders of S must approve the plan as a result of its amendment to provide for the grant of options to acquire P stock. The IRS and the Treasury Department invite comment on this result and are proposing a conforming change to *Example 1*, paragraph (iii) under §1.422-2(b)(6).

These proposed regulations also would provide additional guidance regarding the application of the stockholder approval requirements where an employee stock purchase plan is assumed in connection with a corporate transaction. *Example 3* in §1.423-2(c)(5) of these proposed regulations illustrates this principle.

3. Maximum aggregate number of shares

Section 1.423-2(c)(3) of the existing regulations provides that an employee stock purchase plan must designate the maximum aggregate number of shares that may be issued under the plan. Consistent with §1.422-2(b)(3)(ii), these proposed regulations would provide that the plan may specify that the maximum aggregate number of shares available for grants under the plan may increase annually by a specified percentage of the authorized, issued, or outstanding shares at the date of the adoption of the plan. Further, a plan providing that the maximum aggregate number of shares issued subject to options under the plan may change based on any other specific circumstances will satisfy the requirements of §1.423-2(c)(3) only if the stockholders approve an immediately determinable maximum number of shares that may be issued under the plan in any event. *Examples 4 and 5* in §1.423-2(c)(5) of these proposed regulations illustrate these principles.

4. Employees covered by the plan

Section 423(b)(4) permits an employer to exclude from participation one or more

of the following categories of employees: Employees who have been employed less than two years; Employees who customarily work 20 hours or less per week; Employees who customarily work not more than five months in any calendar year; and Highly compensated employees (HCEs) within the meaning of section 414(q). Section 1.423-1(e)(1) of these proposed regulations has been updated to reflect the 1986 amendment of section 423(b)(4)(D) to substitute “highly compensated employees (within the meaning of section 414(q))” for “officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.” See Public Law 99-514, section 1114(b)(13).

One commentator suggested that the regulations clarify that an employer may exclude from participation a subset of one of the groups set forth in section 423(b)(4). For example, an employer should be permitted to exclude a subset of HCEs, such as officers, from participation in the plan. The commentator further suggested that the regulations clarify that an employer may impose shorter service requirements than those permitted. For example, an employer should be permitted to exclude employees who have been employed less than one year from participation in the plan.

The IRS and the Treasury Department agree that a more inclusive application of the rules of section 423(b)(4) is consistent with the intent of section 423. Accordingly, §1.423-2(e)(2) of these proposed regulations would provide that an employee stock purchase plan does not fail to satisfy the coverage provision of section 423(b)(4) merely because the plan excludes employees who have completed a shorter period of service or whose customary employment is for fewer hours per week or fewer months in a calendar year than is specified in subparts (A), (B) and (C) of section 423(b)(4), provided the exclusion is applied in an identical manner to all employees of every corporation whose employees are granted options under the plan. In addition, these proposed regulations would provide that the terms of an employee stock purchase plan may exclude HCEs: (a) with compensation above a certain level, or (b) who are officers or subject to the disclosure requirements of section 16(a) of the Securities Exchange

Act of 1934, provided the exclusion is applied in an identical manner to all HCEs of every corporation whose employees are granted options under the plan. *Examples 3, 4, 5, 6, and 7* in §1.423–2(e)(6) of these proposed regulations illustrate these principles. (The examples under §1.423–2(e)(3) of the existing regulations have been re-numbered as §1.423–2(e)(6) of these proposed regulations.)

Another commentator suggested that the regulations permit employers to exclude from plan participation employees who are nonresident aliens and who receive no earned income that constitutes income from sources within the United States. The IRS and the Treasury Department agree that it may be appropriate to exclude foreign employees from plan participation in certain limited circumstances. However, unlike section 410(b), section 423 does not provide an exclusion for such nonresident aliens. Accordingly, the IRS and the Treasury Department are constrained by statutory authority from providing a general exclusion from plan participation for employees who are nonresident aliens and who receive no United States source income. Therefore, §1.423–2(e)(3) of these proposed regulations would provide that employees who are citizens or residents of a foreign jurisdiction (without regard to whether they are also citizens of the United States or resident aliens (within the meaning of §7701(b)(1)(A))) may be excluded from the coverage of an employee stock purchase plan only if the grant of an option under the plan to a citizen or resident of the foreign jurisdiction is prohibited under the laws of such jurisdiction or if compliance with the laws of the foreign jurisdiction would cause the plan to violate the requirements of section 423. *Example 8* in §1.423–2(e)(6) of these proposed regulations illustrates this principle.

Another commentator suggested that the regulations permit employers to exclude collectively bargained employees from plan participation. However, unlike section 410(b), section 423 does not provide an exclusion for collectively bargained employees. Accordingly, the IRS and the Treasury Department are again constrained by statutory authority from providing a general exclusion from plan participation for collectively bargained employees.

One commentator suggested that the regulations be amended to provide that an offering will not lose its tax-favored status due to the inadvertent exclusion of employees from plan participation. Rather, the commentator suggested that the granting corporation be permitted to correct certain errors in plan administration through a corrections program that would permit the excluded employees to participate in past offerings under a plan. Such a corrections program is beyond the scope of these regulations. However, the IRS and the Treasury Department invite comments on whether such a program is appropriate (including the statutory authority for such a program) and suggestions for the types of violations that might be covered and the methods of correction.

Section 1.423–2(e)(4) of these proposed regulations includes language that appears under §1.423–2(e)(1) of the existing regulations. Section 1.423–2(e)(2) of the existing regulations has been re-numbered as §1.423–2(e)(5) of these proposed regulations.

5. Equal rights and privileges

Section 423(b)(5) requires that, subject to certain exceptions, an employee stock purchase plan, by its terms, provide that all employees granted options under the plan have the same rights and privileges.

Section 1.423–2(f)(3) of these proposed regulations includes language that appears in §1.423–2(f)(1) of the existing regulations. (The examples in §1.423–2(f)(2) of the existing regulations have been relocated to *Examples 1 and 2* of §1.423–2(f)(7) of these proposed regulations. The example in §1.423–2(f)(4) of the existing regulations has been relocated to *Example 3* of §1.423–2(f)(7). Section 1.423–2(f)(4) of the existing regulations is re-numbered under these proposed regulations as §1.423–2(f)(6)).

One commentator suggested that a plan or offering should not fail to satisfy the equal rights and privileges provision of section 423(b)(5) if the provisions of the plan or offering applied to foreign employees are reasonably designed to avoid adverse consequences for such employee under foreign law as a result of plan participation. The IRS and the Treasury Department agree that in certain limited circumstances it may be appropriate for the

terms of an employee stock purchase plan to be less favorable with respect to foreign employees than those terms are with respect to employees resident in the United States. Accordingly, §1.423–2(f)(4) of these proposed regulations would provide that a plan or offering will not fail to satisfy the requirements of section 423(b)(5) if, in order to comply with the laws of a foreign jurisdiction, the terms of an option granted under a plan or offering to citizens or residents of such foreign jurisdiction (without regard to whether they are also citizens of the United States or resident aliens (within the meaning of §7701(b)(1)(A))) are less favorable than the terms of options granted under the same plan or offering to employees resident in the United States. *Example 4* in §1.423–2(f)(7) of these proposed regulations illustrates this principle.

A plan or offering will not satisfy the requirements of section 423(b)(5), however, if, in order to comply with the laws of a foreign jurisdiction, the terms of the plan or offering are more favorable with respect to citizens or residents of such foreign jurisdiction than the terms of the plan or offering are with respect to employees resident in the United States.

Another commentator suggested that the regulations addressing the carryover of amounts from one offering to another be clarified. In response to this comment, these proposed regulations would clarify §1.423–2(f)(3) of the existing regulations (which has been re-numbered as §1.423–2(f)(5)). Generally, a plan permitting one or more employees to carry forward amounts that were withheld but not applied toward the purchase of stock under an earlier plan or offering and apply such amounts toward the purchase of additional stock under a subsequent plan or offering will be a violation of the equal rights and privileges requirement under section 423(b)(5). However, the carry forward of amounts withheld but not applied toward the purchase of stock under an earlier plan or offering will not violate the equal rights and privileges requirement of section 423(b)(5) if all other employees participating in the current plan or offering are permitted to make direct payments toward the purchase of shares under a subsequent plan or offering in an amount equal to the excess of: (a) the greatest amount that any employee is allowed to carry forward from an earlier

plan or offering over (b) the amount, if any, the employee will carry forward from an earlier plan or offering. *Example 5* in §1.423-2(f)(7) of these proposed regulations illustrates this principle.

Further, a plan will not fail to satisfy the equal rights and privileges requirement of section 423(b)(5) merely because employees are permitted to carry forward amounts representing a fractional share which were withheld but not applied toward the purchase of stock under an earlier plan or offering and apply such amounts toward the purchase of additional stock under a subsequent plan or offering.

6. Option price

Under section 423(b)(6), the option price must not be less than the lesser of: (a) an amount equal to 85 percent of the fair market value of the stock at the time the option is granted, and (b) an amount not less than 85 percent of the fair market value of the stock at the time the option is exercised. Consistent with §1.422-2(e)(1), §1.423-2(g)(1) of these proposed regulations would provide that the option price may be determined in any reasonable manner, including the valuation methods permitted under §20.2031-2 (Estate Tax Regulations), so long as the option price meets the minimum pricing requirements of section 423(b)(6).

7. Date of grant

Section 1.421-1(c) provides, that for purposes of §§1.421-2 through 1.424-1, the language “the date of the granting of the option” and “the time such option is granted” and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. The date of grant for an option granted under an employee stock purchase plan is important for several reasons. First, the favorable tax consequences under section 421 apply to the shares acquired pursuant to the exercise of an option granted under an employee stock purchase plan if the shares are not disposed of within two years from the date of grant of the option or within one year from the date of exercise of the option. Second, the \$25,000 limitation under section 423(b)(8) is determined based on the fair market value of the

stock measured on the date of grant of the option. The date of grant is also important for purposes of determining the employees eligible to participate in the plan and, in certain cases, determining the purchase price of stock under the plan.

Section 1.421-1(c) further provides that a corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable. Because options under an employee stock purchase plan may be priced at the lesser of an amount equal to 85 percent of the fair market value of the stock at the time the option is granted, and an amount not less than 85 percent of the fair market value of the stock at the time the option is exercised, it is not always possible to determine the minimum option price on the first day of an offering. However, many granting corporations intend for the first day of an offering to be the date of grant.

Accordingly, §1.423-2(h)(2) of these proposed regulations would provide that, for purposes of options granted under an employee stock purchase plan, the principles of §1.421-1(c) shall be applied without regard to the requirement that the minimum option price be fixed or determinable in order for the corporate action constituting an offer of stock to be considered complete. As a result, the first day of an offering could be the date of grant for an option issued under an employee stock purchase plan even though the minimum option price is not fixed or determinable on the first day of the offering. These proposed regulations include an amendment to §1.421-1(c).

One commentator questioned whether it is necessary for a plan to contain a limit on the number of shares that can be purchased by each participant during an offering in order for the date of grant of the option to be the first day of an offering. Section 1.423-2(h)(3) of these proposed regulations would provide that the date of grant will be the first day of an offering if the terms of an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each participant during the offering. Similarly, the date of grant will be the first day of an offering if the terms of the plan or offering require the application of a formula

to establish, on the first day of the offering, the maximum number of shares that may be purchased by each participant during the offering.

However, §1.423-2(h)(3) of these proposed regulations does not require that an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each participant during the offering or incorporate a formula to establish a maximum number of shares that may be purchased by each participant during the offering. If the maximum number of shares that can be purchased under an option is not fixed or determinable until the date the option is exercised, then the date of exercise will be the date of grant of the option. The \$25,000 limit under section 423(b)(8) and the limit on the aggregate number of shares that may be issued under an employee stock purchase plan are not sufficient to establish the maximum number of shares that can be purchased under an option so that the date of grant will be the first day of the offering. *Examples 1, 2, 3 and 4* in §1.423-2(h)(4) of these proposed regulations illustrate these principles.

Section 1.423-2(h) of the existing regulations is re-numbered as §1.423-2(h)(1) of these proposed regulations.

8. Annual \$25,000 limitation

Section 423(b)(8) provides that an employee stock purchase plan must, by its terms, provide that no employee may be permitted to purchase stock under all the employee stock purchase plans of his or her employer corporation and its related corporations at a rate which exceeds \$25,000 in fair market value of the stock (determined on the date of grant) for each calendar year in which an option granted to the employee is outstanding and exercisable. Section 1.423-2(i) of these proposed regulations would provide guidance on the operation of the \$25,000 limitation that incorporates and clarifies the guidance provided in the existing regulations.

One commentator suggested that the calculation of the amount of stock that may be purchased under an employee stock purchase plan be determined in a manner consistent with the \$100,000 limitation for incentive stock options described in §1.422-4. The proposed regulations generally adopt this suggestion and would

provide that the \$25,000 limit for employee stock purchase plans is, to the extent possible, calculated in a manner consistent with the \$100,000 limitation for incentive stock options. The timing of both measures is based on when the option first becomes exercisable and both measures are made based on the fair market value of the stock determined at the date of grant. Section 1.423-2(i) of these proposed regulations emphasizes that an employee may purchase up to \$25,000 of stock (based on the fair market value of such stock on the date of grant) in each calendar year during which an option granted to the employee under an employee stock purchase plan is not only outstanding, but also exercisable. *Example 5* in §1.423-2(i)(5) of these proposed regulations illustrates this principle.

For clarification, *Example 1* in §1.423-2(i)(4) of the existing regulations has been separated into *Example 1* and *Example 4* in §1.423-2(i)(5) of these proposed regulations.

9. Special rule where option price is between 85 percent and 100 percent of the value of the stock

Section 423(c) provides a special rule for calculating the timing and amount of compensation income that must be recognized when the option price for a share is between 85 and 100 percent of the value of the share on the date of grant. Generally, the income recognized is the lesser of: (a) the excess of the fair market value of the share on the date of grant over the option price, and (b) the excess of the fair market value of the share at the time of disposition (or death) over the option price. The flush language of section 423(c) provides that if the exercise price is not known on the date of grant, the exercise price shall be determined as if the option were exercised on the date of grant.

One commentator suggested that it is unclear how this special rule and the flush language of section 423(c) apply when the option price is determined based on some percentage of the value of a share on the last day of an offering. *Example 3* of §1.423-2(k)(3) of the existing regulations specifically addresses this issue and has been retained in §1.423-2(k)(3) of these proposed regulations. *Example 4* has been added under §1.423-2(k)(3) to illustrate

the tax consequences under an employee stock purchase plan that uses a look-back feature to determine the exercise price of the option.

Proposed Effective Date

These regulations under section 423 are proposed to apply as of January 1, 2010, and will apply to any option issued under an employee stock purchase plan that is granted on or after that date. Taxpayers may rely on these proposed regulations for the treatment of any option issued under an employee stock purchase plan that is granted after publication of these proposed regulations in the **Federal Register**.

Special Analyses

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

Comments and Requests for Public Hearing

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

Drafting Information

The principal author of these proposed regulations is Thomas Scholz, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.421-1, paragraphs (c)(1) and (j)(1) are revised to read as follows:

§1.421-1 Meaning and use of certain terms.

* * * * *

(c) *Time and date of granting option.* (1) For purposes of this section and §§1.421-2 through 1.424-1, the language “the date of the granting of the option” and “the time such option is granted,” and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. Except as set forth in §1.423-2(h)(2), a corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable.

* * * * *

(j) *Effective/applicability date—(1) In general.* Except for paragraph (c)(1), these regulations are effective on August 3, 2004. Upon the date of publication of the Treasury decision adopting paragraph (c)(1) of this section as a final regulation in the **Federal Register**, paragraph (c)(1) will apply as of January 1, 2010.

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Par. 3. Section 1.422-2, paragraph (b)(6), *Example 1* (iii) is revised to read as follows:

§1.422-2 Incentive stock options defined.

* * * * *

(b) * * *

(6) * * *

Example 1. * * *

(iii) Assume the same facts as in paragraph (i) of this Example 1. Assume further that the plan was approved by the stockholders of S (in this case, P) on March 1, 2006. On January 1, 2008, S changes the plan to provide that incentive stock options for P stock will be granted to S employees under the plan. Because there is a change in the stock available for grant under the plan, the change is considered the adoption of a new plan that must be approved by the stockholder of S (in this case, P) within 12 months before or after January 1, 2008.

* * * * *

Par. 4. Section 1.422-5, paragraph (f)(1) is revised to read as follows:

§1.422-5 Permissible provisions.

* * * * *

(f) *Effective/applicability date*—(1) *In general.* Except for §1.422-2(b)(6), *Example 1* (iii), these regulations are effective on August 3, 2004. Upon the date of publication of the Treasury decision adopting Section 1.422-2(b)(6), *Example 1* (iii) of this section as a final regulation in the **Federal Register**, Section 1.422-2(b)(6), *Example 1* (iii) will apply as of January 1, 2010.

* * * * *

Par. 5. Section 1.423-1 is revised to read as follows:

§1.423-1 Applicability of section 421(a).

(a) *General rule.* Subject to the provisions of section 423(c) and paragraph (k) of §1.423-2, the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to the individual's exercise of an option granted under an employee stock purchase plan if the following conditions are satisfied—

(1) The individual makes no disposition of such share before the later of the expiration of the two-year period from the date of the grant of the option pursuant to which such share was transferred or the expiration of the one-year period from the date of transfer of such share to the individual; and

(2) At all times during the period beginning on the date of the grant of the option and ending on the day three months before the date of exercise, the individual was an employee of the corporation granting the option, a related corporation, or a corporation (or a related corporation) substituting or assuming the stock option in a transaction to which section 424(a) applies.

(b) *Cross-references.* For rules relating to the requisite employment relationship, see paragraph (h) of §1.421-1. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of §1.421-2. For the definition of the term *disposition*, see section 424(c) and paragraph (c) of §1.424-1. For the definition of the term *related corporation*, see paragraph (i) of §1.421-1.

(c) *Effective/applicability date.* Upon the date of publication of the Treasury decision adopting the rules of this section as a final regulation in the **Federal Register**, these rules will apply as of January 1, 2010.

Par. 6. Section 1.423-2 is revised to read as follows:

§1.423-2 Employee stock purchase plan defined.

(a) *In general*—(1) The term *employee stock purchase plan* means a plan that meets the requirements of paragraph (a)(2)(i) through (ix) of this section. If the terms of the plan do not satisfy the requirements of paragraph (a)(2)(iii) through (ix) of this section, such requirements may be satisfied by the terms of an offering made under the plan. However, where the requirements of paragraph (a)(2)(iii) through (ix) of this section are satisfied by the terms of an offering, such requirements will be treated as satisfied only with respect to options exercised under that offering. The plan and the terms of an offering must be in writing or electronic form, provided that such writing or electronic form is adequate to establish the terms of the plan or offering, as applicable.

(2) To qualify as an employee stock purchase plan under this section and §1.423-1, the plan must meet all of the following requirements—

(i) The plan must provide that options can be granted only to employees of the employer corporation or of a related corporation (as defined in paragraph (i) of

§1.421-1) to purchase stock in any such corporation (see paragraph (b) of this section);

(ii) The plan must be approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted (see paragraph (c) of this section);

(iii) Under the terms of the plan, an employee cannot be granted an option if, immediately after the option is granted, the employee owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or of a related corporation (see paragraph (d) of this section);

(iv) Under the terms of the plan, options must be granted to all employees of any corporation whose employees are granted any options by reason of their employment by the corporation (see paragraph (e) of this section);

(v) Under the terms of the plan, all employees granted options must have the same rights and privileges (see paragraph (f) of this section);

(vi) Under the terms of the plan, the option price cannot be less than the lesser of—

(A) An amount equal to 85 percent of the fair market value of the stock at the time the option is granted, or

(B) An amount not less than 85 percent of the fair market value of the stock at the time the option is exercised (see paragraph (g) of this section);

(vii) Under the terms of the plan, options cannot be exercised after the expiration of—

(A) Five years from the date the option is granted if, under the terms of such plan, the option price cannot be less than 85 percent of the fair market value of the stock at the time the option is exercised, or

(B) Twenty-seven months from the date the option is granted, if the option price is not determined in the manner described in paragraph (A) (see paragraph (h) of this section);

(viii) Under the terms of the plan, no employee may be granted an option that permits the employee's rights to purchase stock under all employee stock purchase plans of the employer corporation and its related corporations to accrue at a rate that exceeds \$25,000 of fair market value of the stock (determined at the time the option is granted) for each calendar year in which

the option is outstanding at any time (see paragraph (i) of this section); and

(ix) Under the terms of the plan, options are not transferable by the optionee other than by will or the laws of descent and distribution, and are exercisable, during the lifetime of the optionee, only by the optionee (see paragraph (j) of this section).

(3) The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time the option is granted. If the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under the plan, the option will not be treated as granted under an employee stock purchase plan. If an option with terms that are inconsistent with the terms of the plan or an offering under the plan is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and the employee is not granted an option under the offering that qualifies as an option granted under an employee stock purchase plan, the offering will not meet the requirements of paragraph (e) of this section. Accordingly, none of the options granted under the offering will be eligible for the special tax treatment of section 421. However, if an option with terms that are inconsistent with the terms of the plan or an offering under the plan is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, the option will not be treated as an option granted under an employee stock purchase plan, and the grant of the option will not disqualify the options granted under the plan or offering. If, at the time of grant, an option qualifies as an option granted under an employee stock purchase plan, but the terms of the option are not satisfied, the option will not be treated as granted under an employee stock purchase plan and this failure to comply with the terms of the option will not disqualify the options granted under the plan or offering.

(4) *Examples.* The following examples illustrate the principles of paragraph (a)(3):

Example 1. Corporation A operates an employee stock purchase plan under which options for A stock are granted to employees of A. The terms of an offering provide that the option price will be 90 percent of the fair market value of A stock on the date of exercise. A grants an option under the offering to Employee Z, an employee of A. The terms of the option provide that the option price will be 85 percent of

the fair market value of A stock on the date of exercise. Because the terms of Z's option are inconsistent with the terms of the offering, the option granted to Z will not be treated as an option granted under the employee stock purchase plan. Further, unless Z is granted an option under the offering that qualifies as an option granted under the employee stock purchase plan, the offering will not meet the requirements of paragraph (e) of this section and none of the options granted under the offering will be eligible for the special tax treatment of section 421.

Example 2. Corporation B operates an employee stock purchase plan that provides that options for B stock may only be granted to employees of B. Under the terms of the plan, options may not be granted to consultants and other non-employees. B grants an option under the plan to Consultant Y, a consultant of B. Because Y is ineligible to receive an option under the plan by reason of Y's status as a non-employee, the grant of the option to Y is inconsistent with the terms of the plan and the option granted to Y will not be treated as an option granted under the employee stock purchase plan. However, the grant of the option to Y will not disqualify the options granted under the plan or offering because Y was not entitled to the grant of an option under the plan.

Example 3. Corporation C operates an employee stock purchase plan under which options for C stock are granted to employees of C. C grants an option under the plan to Employee X, an employee of C who is a highly compensated employee. The terms of the employee stock purchase plan exclude highly compensated employees from participation in the plan. Because X is ineligible to receive an option under the plan by reason of X's exclusion from participation in the plan, the option granted to X will not be treated as an option granted under the employee stock purchase plan. However, the grant of the option to X will not disqualify the options granted under the plan or offering because X was not entitled to the grant of an option under the plan.

Example 4. Corporation D operates an employee stock purchase plan under which options for D stock are granted to employees of D. D grants an option under the plan to Employee W, an employee of D. The terms of the option provide that the option price will be 90 percent of the fair market value of D stock on the date of exercise. On the date of exercise, W pays only 85 percent of the fair market value of D stock. Because the terms of W's option are not satisfied, the option granted to W will not be treated as an option granted under the employee stock purchase plan. However, the failure to comply with the terms of the option granted to W will not disqualify the options granted under the plan or offering.

(b) *Options restricted to employees.* An employee stock purchase plan must provide that options can be granted only to employees of the employer corporation (or employees of its related corporations) to purchase stock in the employer corporation (or one of its related corporations). If such a provision is not included in the terms of the plan, the plan will not be an employee stock purchase plan and options granted under the plan will not qualify for the special tax treatment of section 421.

For rules relating to the employment requirement, see paragraph (h) of §1.421-1.

(c) *Stockholder approval*—(1) An employee stock purchase plan must be approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter, bylaws and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval, then an employee stock purchase plan must be approved—

(i) By a majority of the votes cast at a duly held stockholder's meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(ii) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (such as, an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

(2) For purposes of the stockholder approval required by this paragraph (c), ordinarily, a plan is adopted when it is approved by the granting corporation's board of directors, and the date of the board's action is the reference point for determining whether stockholder approval occurs within the applicable 24-month period. However, if the board's action is subject to a condition (such as stockholder approval) or the happening of a particular event, the plan is adopted on the date the condition is met or the event occurs, unless the board's resolution fixes the date of approval as the date of the board's action.

(3) An employee stock purchase plan, as adopted and approved, must designate the maximum aggregate number of shares that may be issued under the plan, and the corporations or class of corporations whose employees may be offered options under the plan. A plan that merely provides that the number of shares that may be issued under the plan may not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan does not satisfy the requirements of this paragraph (c)(3). However, the maximum aggregate number of shares

that may be issued under the plan may be stated in terms of a percentage of the authorized, issued, or outstanding shares on the date of the adoption of the plan. The plan may specify that the maximum aggregate number of shares available for grants under the plan may increase annually by a specified percentage of the authorized, issued, or outstanding shares on the date of the adoption of the plan. A plan that provides that the maximum aggregate number of shares that may be issued as options under the plan may change based on any other specific circumstances satisfies the requirements of this paragraph only if the stockholders approve an immediately determinable maximum number of shares that may be issued under the plan in any event. If there is more than one employee stock purchase plan under which options may be granted and stockholders of the granting corporation merely approve a maximum aggregate number of shares that are available for issuance under the plans, the stockholder approval requirements described in paragraph (c)(1) of this section are not satisfied. A separate maximum aggregate number of shares available for issuance pursuant to options must be specified and approved for each plan.

(4) Once an employee stock purchase plan is approved by the stockholders of the granting corporation, the plan need not be reapproved by the stockholders of the granting corporation within the prescribed 24-month period unless the plan is amended or changed in a manner that is considered the adoption of a new plan. Any increase in the aggregate number of shares that may be issued under the plan (other than an increase merely reflecting a change in the number of outstanding shares, such as a stock dividend or stock split) will be considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the granting corporation and its related corporations. The group from among which such changes and designations are

permitted without additional stockholder approval may include corporations having become parents or subsidiaries of the granting corporation after the adoption and approval of the plan. In addition, a change in the granting corporation or the stock available for purchase under the plan will be considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period. Any other changes in the terms of an employee stock purchase plan are not considered the adoption of a new plan and, thus, do not require stockholder approval.

(5) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1—(i) Corporation E is a subsidiary of Corporation F, a publicly traded corporation. On January 1, 2010, E adopts an employee stock purchase plan under which options for E stock are granted to E employees.

(ii) To meet the requirements of paragraph (c)(1) of this section, the plan must be approved by the stockholders of E (in this case, F) within 12 months before or after January 1, 2010.

(iii) Assume the same facts as in paragraph (i) of this *Example 1*, except that the plan was approved by the stockholders of E (in this case, F) on March 1, 2010. On January 1, 2012, E changes the plan to provide that options for F stock will be granted to E employees under the plan. Because there is a change in the stock available for grant under the plan, under paragraph (c)(4) of this section, the change is considered the adoption of a new plan that must be approved by the stockholders of E (in this case, F) within 12 months before or after January 1, 2012.

Example 2—(i) Assume the same facts as in paragraph (i) of *Example 1*, except that on March 15, 2011, F completely disposes of its interest in E. Thereafter, E continues to grant options for E stock to E employees under the plan.

(ii) The new E options are granted under a plan that meets the stockholder approval requirements of paragraph (c)(1) of this section without regard to whether E seeks approval of the plan from the stockholders of E after F disposes of its interest in E.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that under the plan as adopted on January 1, 2010, only options for F stock are granted to E employees. Assume further that, after F disposes of its interest in E, E changes the plan to provide for the grant of options for E stock to E employees. Because there is a change in the stock available for purchase or grant under the plan, under paragraph (c)(4) of this section, the stockholders of E must approve the plan within 12 months before or after the change to the plan to meet the stockholder approval requirements of paragraph (c) of this section.

Example 3—(i) Corporation G maintains an employee stock purchase plan. Corporation H does not maintain an employee stock purchase plan. On May 15, 2010, G and H consolidate under State law to form one corporation. The new corporation is named Corporation H. The consolidation agreement describes

the G plan, including the maximum aggregate number of shares available for issuance under the plan after the consolidation. Additionally, the consolidation agreement states that the plan will be continued by H after the consolidation. The consolidation agreement is unanimously approved by the stockholders of G and H on May 1, 2010. H assumes the plan formerly maintained by G and continues to grant options under the plan to all eligible employees.

(ii) Because there is a change in the granting corporation (from G to H), under paragraph (c)(4) of this section, H is considered to have adopted a new plan. Because the plan is fully described in the consolidation agreement, including the maximum aggregate number of shares available for issuance under the plan, the approval of the consolidation agreement by the stockholders constitutes approval of the plan. Thus, the stockholder approval of the consolidation agreement satisfies the stockholder approval requirements of paragraph (c)(1) of this section, and the plan is considered to be adopted by H and approved by its stockholders on May 1, 2010.

Example 4. Corporation I adopts an employee stock purchase plan on November 1, 2010. On that date, there are two million shares of I stock outstanding. The plan provides that the maximum aggregate number of shares that may be issued under the plan may not exceed 15 percent of the number of shares of I stock outstanding on November 1, 2010. Because the maximum aggregate number of shares that may be issued under the plan is designated in the plan, the requirements of paragraph (c)(3) of this section are met.

Example 5—(i) Corporation J adopts an employee stock purchase plan on March 15, 2010. The plan provides that the maximum aggregate number of shares of J stock available for issuance under the plan is 50,000, increased on each anniversary date of the adoption of the plan by 5 percent of the then outstanding shares. Because the maximum aggregate number of shares is not designated under the plan, the requirements of paragraph (c)(3) of this section are not met.

(ii) Assume the same facts as in paragraph (i) of this *Example 5*, except that the plan provides that the maximum aggregate number of shares available under the plan is the lesser of (a) 50,000 shares, increased each anniversary date of the adoption of the plan by 5 percent of the then-outstanding shares, or (b) 200,000 shares. Because the maximum aggregate number of shares that may be issued under the plan is designated as the lesser of two numbers, one of which provides an immediately determinable maximum aggregate number of shares that may be issued under the plan in any event, the requirements of paragraph (c)(3) of this section are met.

(d) *Options granted to certain shareholders*—(1) An employee stock purchase plan must by its terms provide that an employee cannot be granted an option if the employee, immediately after the option is granted, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or a related corporation. In determining whether the stock ownership of an employee equals or ex-

ceeds this 5 percent limit, the rules of section 424(d) (relating to attribution of stock ownership) shall apply, and stock that the employee may purchase under outstanding options (whether or not the options qualify for the special tax treatment afforded by section 421(a)) shall be treated as stock owned by the employee. An option is outstanding for purposes of this paragraph (d) although under its terms it may be exercised only in installments or after the expiration of a fixed period of time. If an option is granted to an employee whose stock ownership (as determined under this paragraph (d)) exceeds the limitation set forth in this paragraph (d), no portion of the option will be treated as having been granted under an employee stock purchase plan.

(2) The determination of the percentage of the total combined voting power or value of all classes of stock of the employer corporation (or a related corporation) that is owned by the employee is made by comparing the voting power or value of the shares owned (or treated as owned) by the employee to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to the employee. The aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option does not include the voting power or value of treasury shares or shares authorized for issue under outstanding options held by the employee or any other person.

(3) *Examples.* The following examples illustrate the principles this paragraph (d):

Example 1. Employee V, an employee of Corporation K, owns 6,000 shares of K common stock, the only class of K stock outstanding. K has 100,000 shares of its common stock outstanding. Because V owns 6 percent of the combined voting power or value of all classes of K stock, K cannot grant an option to V under K's employee stock purchase plan. If V's father and brother each owned 3,000 shares of K stock and V did not own any K stock, then the result would be the same because, under section 424(d), an individual is treated as owning stock held by the person's father and brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, V merely held an option on 6,000 shares of K stock, irrespective of whether the transfer of stock under the option could qualify for the special tax treatment of section 421, because this paragraph (d) provides that stock the employee may purchase under outstanding options is treated as stock owned by such employee.

Example 2. Assume the same facts as in *Example 1*, except that K is a subsidiary corporation of Corporation L. Irrespective of whether V owns any L stock, V cannot receive an option from L under

L's employee stock purchase plan because he owns 5 percent of the total combined voting power of all classes of stock of a subsidiary of L, in this example, K. An employee who owns (or is treated as owning) stock in excess of the limitation of this paragraph (d), in any corporation in a group of related corporations, consisting of a parent and its subsidiary corporations, cannot receive an option under an employee stock purchase plan from any corporation in the group.

Example 3. Employee U is an employee of Corporation M. M has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming U does not own (and is not treated as owning) any stock in M or in any related corporation of M, M may grant an option to U under its employee stock purchase plan for 4,999 shares, because immediately after the grant of the option, U would not own 5 percent or more of the combined voting power or value of all classes of M stock actually issued and outstanding at such time. The 4,999 shares that U would be treated as owning under this paragraph (d) would not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether U's stock ownership exceeds the limitation of this paragraph (d).

Example 4. Assume the same facts as in *Example 3* but instead of an option for 4,999 shares, M grants U an option, purportedly under its employee stock purchase plan, for 5,000 shares. No portion of this option will be treated as granted under an employee stock purchase plan because U's stock ownership exceeds the limitation of this paragraph (d).

(e) *Employees covered by plan*—(1) Subject to the provisions of this paragraph (e) and the limitations of paragraphs (d), (f) and (i) of this section, an employee stock purchase plan must, by its terms, provide that options are to be granted to all employees of any corporation whose employees are granted any of such options by reason of their employment by the corporation, except that one or more of the following categories of employees may be excluded from the coverage of the plan—

(i) Employees who have been employed less than two years;

(ii) Employees whose customary employment is 20 hours or less per week;

(iii) Employees whose customary employment is for not more than five months in any calendar year; and

(iv) Highly compensated employees (within the meaning of section 414(q)).

(2) An employee stock purchase plan does not fail to satisfy the coverage provision of paragraph (e)(1) of this section in the following circumstances—

(i) The plan excludes employees who have completed a shorter period of service or whose customary employment is for fewer hours per week or fewer months in a calendar year than is specified in paragraph (e)(1)(i), (ii) and (iii), provided the

exclusion is applied in an identical manner to all employees of every corporation whose employees are granted options under the plan.

(ii) The plan excludes highly compensated employees (within the meaning of section 414(q)) with compensation above a certain level or who are officers or subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934, provided the exclusion is applied in an identical manner to all highly compensated employees of every corporation whose employees are granted options under the plan.

(3) Notwithstanding paragraph (e)(1) of this section, employees who are citizens or residents of a foreign jurisdiction (without regard to whether they are also citizens of the United States or resident aliens (within the meaning of section 7701(b)(1)(A))) may be excluded from the coverage of an employee stock purchase plan under the following circumstances—

(i) The grant of an option under the plan to a citizen or resident of the foreign jurisdiction is prohibited under the laws of such jurisdiction; or

(ii) Compliance with the laws of the foreign jurisdiction would cause the plan to violate the requirements of section 423.

(4) No option granted under a plan or offering that excludes from participation any employees, other than those who may be excluded under this paragraph (e), and those barred from participation by reason of paragraphs (d), (f) and (i) of this section, can be regarded as having been granted under an employee stock purchase plan. If an option is not granted to any employee who is entitled to the grant of an option under the terms of the plan or offering, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. However, a plan that, by its terms, permits all eligible employees to elect to participate in an offering will not violate the requirements of this paragraph solely because eligible employees who elect not to participate in the offering are not granted options pursuant to such offering.

(5) For purposes of this paragraph (e), the existence of the employment relationship between an individual and the corporation participating under the plan will be determined under paragraph (h) of §1.421-1.

(6) *Examples.* The following examples illustrate the principles of this paragraph (e):

Example 1. Corporation N has a stock purchase plan that meets all the requirements of paragraph (a)(2) of this section except that options are not required to be granted to employees whose weekly rate of pay is less than \$1,000. As a matter of corporate practice, however, N grants options under its plan to all employees, irrespective of their weekly rate of pay. Even though N's plan is operated in compliance with the requirements of this paragraph (e), N's plan is not an employee stock purchase plan because the terms of the plan exclude a category of employees that is not permitted under this paragraph (e).

Example 2. Assume the same facts as in *Example 1*, except that the first offering under N's plan provides that options will be granted to all employees of N. The terms of the first offering will be treated as part of the terms of N's plan, but only for purposes of the first offering. Because the terms of the first offering satisfy the requirements of this paragraph (e), stock transferred pursuant to options exercised under the first offering will be treated as stock transferred pursuant to the exercise of options granted under an employee stock purchase plan for purposes of section 421.

Example 3. Corporation O has a stock purchase plan that excludes from participation all employees who have been employed less than one year. Assuming all other requirements of paragraph (a)(2) of this section are satisfied, O's plan qualifies as an employee stock purchase plan under section 423.

Example 4. Corporation P has a stock purchase plan that excludes from participation clerical employees who have been employed less than two years. However, non-clerical employees with less than two years of service are permitted to participate in the plan. P's plan is not an employee stock purchase plan because the exclusion of employees who have been employed less than two years applies only to certain employees of P and is not applied in an identical manner to all employees of P. If, instead, P's plan excludes from participation all employees (both clerical and non-clerical) who have been employed less than two years, then P's plan would qualify as an employee stock purchase plan under section 423 assuming all other requirements of paragraph (a)(2) of this section are satisfied.

Example 5. Corporation Q has a stock purchase plan that excludes from participation all officers who are highly compensated employees (within the meaning of section 414(q)). Assuming all other requirements of paragraph (a)(2) of this section are satisfied, Q's plan qualifies as an employee stock purchase plan under section 423.

Example 6. Corporation R maintains an employee stock purchase plan that excludes from participation all highly compensated employees (within the meaning of section 414(q)), except highly compensated employees who are officers of R. R's plan is not an employee stock purchase plan because the exclusion of all highly compensated employees except highly compensated employees who are officers of R is not a permissible exclusion under paragraph (e)(2)(ii) of this section.

Example 7. Corporation S is the parent corporation of Subsidiary YY and Subsidiary ZZ. S maintains an employee stock purchase plan with both YY and

ZZ participating under the plan. Under the terms of the plan, all employees of YY and ZZ are permitted to participate in the plan with the exception of ZZ's highly compensated employees with annual compensation greater than \$300,000. S's plan is not an employee stock purchase plan because the exclusion of highly compensated employees with annual compensation greater than \$300,000 is not applied in an identical manner to all employees of YY and ZZ.

Example 8. The laws of Country A require that options granted to residents of Country A be transferable during the lifetime of the option recipient. Corporation T has a stock purchase plan that excludes residents of Country A from participation in the plan. Because compliance with the laws of Country A would cause options granted to residents of Country A to violate paragraph (j) of this section, T may exclude residents of Country A from participation in the plan. Assuming all other requirements of paragraph (a)(2) of this section are satisfied, T's plan qualifies as an employee stock purchase plan under section 423.

(f) *Equal rights and privileges*—(1) Except as otherwise provided in paragraphs (f)(2) through (f)(6) of this section, an employee stock purchase plan must, by its terms, provide that all employees granted options under the plan shall have the same rights and privileges. Thus, the provisions applying to one option under an offering (such as the provisions relating to the method of payment for the stock and the determination of the purchase price per share) must apply to all other options under the offering in the same manner. If all the options granted under a plan or offering do not, by their terms, give the respective optionees the same rights and privileges, none of the options will be treated as having been granted under an employee stock purchase plan for purposes of section 421.

(2) The requirements of this paragraph (f) do not prevent the maximum amount of stock that an employee may purchase from being determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation, of all employees.

(3) A plan or offering will not fail to satisfy the requirements of this paragraph (f) because the plan or offering provides that no employee may purchase more than a maximum amount of stock fixed under the plan.

(4) A plan or offering will not fail to satisfy the requirements of this paragraph (f) if, in order to comply with the laws of a foreign jurisdiction, the terms of an option granted under a plan or offering to citizens or residents of such foreign jurisdiction (without regard to whether they are

also citizens of the United States or resident aliens (within the meaning of section 7701(b)(1)(A))) are less favorable than the terms of options granted under the same plan or offering to employees resident in the United States.

(5)(i) Except as provided in this paragraph and paragraph (f)(5)(ii) of this section, a plan permitting one or more employees to carry forward amounts that were withheld but not applied toward the purchase of stock under an earlier plan or offering and apply the amounts towards the purchase of additional stock under a subsequent plan or offering will be a violation of the equal rights and privileges under paragraph (f)(1) of this section. However, the carry forward of amounts withheld but not applied toward the purchase of stock under an earlier plan or offering will not violate the equal rights and privileges requirement of paragraph (f)(1) of this section if all other employees participating in the current plan or offering are permitted to make direct payments toward the purchase of shares under a subsequent plan or offering in an amount equal to the excess of the greatest amount which any employee is allowed to carry forward from an earlier plan or offering over the amount, if any, the employee will carry forward from an earlier plan or offering.

(ii) A plan will not fail to satisfy the requirements of this section merely because employees are permitted to carry forward amounts representing a fractional share, that were withheld but not applied toward the purchase of stock under an earlier plan or offering and apply the amounts toward the purchase of additional stock under a subsequent plan or offering.

(6) Paragraph (f) does not prohibit the delaying of the grant of an option to any employee who is barred from being granted an option solely by reason of the employee's failing to meet a minimum service requirement set forth in paragraph (e)(1) of this section until the employee meets such requirement.

(7) *Examples.* The following examples illustrate the principles of this paragraph (f):

Example 1. Corporation U has an employee stock purchase plan that provides that the maximum amount of stock that each employee may purchase under the offering is one share for each \$100 of annual gross pay. The plan meets the requirements of this paragraph (f).

Example 2. Corporation V has an employee stock purchase plan that provides that the maximum amount of stock that each employee may purchase under the offering is one share for each \$100 of annual gross pay up to and including \$10,000, and two shares for each \$100 of annual gross pay in excess of \$10,000. The plan will not meet the requirements of this paragraph (f) because the amount of stock that may be purchased under the plan is not based on a uniform relationship to the total compensation of all employees.

Example 3. Corporation W has an employee stock purchase plan that provides that options to purchase stock in an amount equal to ten percent of an employee's annual salary at a price equal to 85 percent of the fair market value on the first day of the offering will be granted to all employees other than those who have been employed less than 18 months. In addition, the plan provides that employees who have not yet met the minimum service requirements on the first day of the offering will be granted similar options on the date the 18 month service requirement has been attained. The plan meets the requirements of this paragraph (f).

Example 4. Corporation X has an employee stock purchase plan that provides that options to purchase stock at a price equal to 90 percent of the fair market value at the time the option is exercised will be granted to all employees. The laws of Country B provide that options granted to employees who are residents of Country B must have a purchase price not less than 95 percent of the fair market value at the time the option is exercised. The plan will not fail to satisfy the requirements of this paragraph (f) merely because the residents of Country B are granted options under the plan to purchase stock at a price equal to 95 percent of the fair market value at the time the option is exercised.

Example 5. Corporation Y maintains an employee stock purchase plan. Employee T is employed by Y. T is granted an option under the current offering to purchase a maximum of 100 shares of Y stock at an option price equal to 85 percent of the fair market value of the stock at exercise. The plan permits the carry forward of withheld but unused amounts from an earlier offering. Prior to the exercise date, \$2000 of T's salary has been withheld and is available to be applied toward the purchase of Y stock. On the exercise date, the fair market value of Y stock is \$20 per share. T is able to purchase 100 shares of Y stock at \$17 per share for an aggregate purchase price of \$1700. T can carry forward \$300 to the subsequent offering. Each employee in the subsequent offering other than T will be permitted to make direct payments toward the purchase of shares under the subsequent offering in a maximum amount of \$300 less any amount the employee has carried forward from an earlier offering. The plan does not violate the equal rights and privileges requirement of this paragraph (f).

(g) *Option price*—(1) An employee stock purchase plan must, by its terms, provide that the option price will not be less than the lesser of—

(i) An amount equal to 85 percent of the fair market value of the stock at the time the option is granted, or

(ii) An amount that under the terms of the option may not be less than 85 percent of the fair market value of the stock at the time the option is exercised.

(2) The option price may be determined in any reasonable manner, including the valuation methods permitted under §20.2031-2, so long as the option price meets the minimum pricing requirements of this paragraph (g). For general rules relating to the option price, see paragraph (e) of §1.421-1. For rules relating to the determination of when an option is granted, see paragraph (c) of §1.421-1 and §1.423-2(h)(2). Any option that does not meet the minimum pricing requirements of this paragraph (g) will not be treated as an option granted under an employee stock purchase plan irrespective of whether the plan or offering satisfies those requirements. If an option that does not meet the minimum pricing requirements is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and the employee is not granted an option under such offering that qualifies as an option granted under an employee stock purchase plan, the offering will not meet the requirements of paragraph (e) of this section. Accordingly, none of the options granted under the offering will be eligible for the special tax treatment of section 421.

(3) The option price may be stated either as a percentage or as a dollar amount. If the option price is stated as a dollar amount, then the requirement of this paragraph (g) can only be met by a plan or offering in which the price is fixed at not less than 85 percent of the fair market value of the stock at the time the option is granted. If the fixed price is less than 85 percent of the fair market value of the stock at grant, then the option cannot meet the requirement of this paragraph (g) even if a decline in the fair market value of the stock results in such fixed price being not less than 85 percent of the fair market value of the stock at the time the option is exercised, because that result was not certain to occur under the terms of the option.

(4) *Examples.* The following examples illustrate the principles of this paragraph (g):

Example 1. Corporation Z has an employee stock purchase plan that provides that the option price will be 85 percent of the fair market value of the stock on the first day of the offering (which is the date of

grant in this case), or 85 percent of the fair market value of the stock at exercise, whichever amount is the lesser. Upon the exercise of an option issued under Z's plan, Z agrees to accept an option price that is less than the minimum amount allowable under the terms of such plan. Notwithstanding that the option was issued under an employee stock purchase plan, the transfer of stock pursuant to the exercise of such option does not satisfy the requirement of this paragraph (g) and cannot qualify for the special tax treatment of section 421.

Example 2. Corporation AA has an employee stock purchase plan that provides that the option price is set at 85 percent of the fair market value of AA stock at exercise, but not less than \$80 per share. On the first day of the offering (which is the date of grant in this case), the fair market value of AA stock is \$100 per share. The option satisfies the requirement of this paragraph (g), and can qualify for the special tax treatment of section 421.

Example 3. Assume the same facts as in *Example 2*, except that the option price is set at 85 percent of the fair market value of AA stock at exercise, but not more than \$80 per share. This option cannot satisfy the requirement of this paragraph (g) irrespective of whether, at the time the option is exercised, 85 percent of the fair market value of AA stock is \$80 or less.

(h) *Option period*—(1) An employee stock purchase plan must, by its terms, provide that options granted under the plan cannot be exercised after the expiration of 27 months from the date of grant unless, under the terms of the plan, the option price is not less than 85 percent of the fair market value of the stock at the time of the exercise of the option. If the option price is not less than 85 percent of the fair market value of the stock at the time the option is exercised, then the option period provided under the plan must not exceed five years from the date of grant. If the requirements of this paragraph (h) are not met by the terms of the plan or offering, then options issued under such plan or offering will not be treated as options granted under an employee stock purchase plan irrespective of whether the options, by their terms, are exercisable beyond the period allowable under this paragraph (h). An option that provides that the option price is not less than 85 percent of the fair market value of the stock at exercise may have an option period of 5 years irrespective of whether the fair market value of the stock at exercise is more or less than the fair market value of the stock at grant. However, if the option provides that the option price is 85 percent of the fair market value of the stock at exercise, but not more than some other fixed amount determined in accordance with the provisions of paragraph (g) of this section,

then irrespective of the price paid on exercise, the option period must not be more than 27 months.

(2) Section 1.421-1(c) provides that, for purposes of §§1.421-1 through 1.424-1, the language *the date of the granting of the option and the time such option is granted*, and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. With respect to options granted under an employee stock purchase plan, the principles of §1.421-1(c) shall be applied without regard to the requirement that the minimum option price must be fixed or determinable in order for the corporate action constituting an offer of stock to be considered complete.

(3) The date of grant will be the first day of an offering if the terms of an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each employee during the offering. Similarly, the date of grant will be the first day of an offering if the terms of the plan or offering require the application of a formula to establish, on the first day of the offering, the maximum number of shares that may be purchased by each employee during the offering. It is not required that an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each employee during the offering or incorporate a formula to establish a maximum number of shares that may be purchased by each employee during the offering. If the maximum number of shares that can be purchased under an option is not fixed or determinable until the date the option is exercised, then the date of exercise will be the date of grant of the option.

(4) *Examples.* The following examples illustrate the principles of this paragraph (h):

Example 1—(i) Corporation BB has an employee stock purchase plan that provides that the option price will be the lesser of 85 percent of the fair market value of the stock on the first day of an offering or 85 percent of the fair market value of the stock on the last day of the offering. Options are exercised on the last day of the offering. One million shares of BB stock are reserved for issuance under the plan. The plan provides that no employee may be permitted to purchase stock under the plan at a rate that exceeds \$25,000 in fair market value of the BB stock (determined on the date of grant) for each calendar year dur-

ing which an option granted to the employee is outstanding and exercisable. The terms of each option granted under an offering provide that a maximum of 500 shares may be purchased by the option recipient during the offering. Because the maximum number of shares that can be purchased under the option is fixed and determinable on the first day of the offering, the date of grant for the option is the first day of the offering.

(ii) Assume the same facts as in paragraph (i) of *Example 1* except that BB's plan excludes all employees who have been employed less than 18 months. The plan provides that employees who have not yet met the minimum service requirements on the first day of an offering will be granted an option on the date the 18-month service requirement has been attained. With respect to those employees who have been employed less than 18 months on the first day of an offering, the date of grant for the option is the date the 18-month service requirement has been attained.

Example 2. Assume the same facts as in paragraph (i) of *Example 1* except that the terms of each option granted do not provide that a maximum of 500 shares may be purchased by the option recipient during the offering. Notwithstanding the fixed number of shares reserved for issuance under the plan and the \$25,000 limitation set forth in the plan, the maximum number of shares that can be purchased under the option is not fixed or determinable until the last day of the offering when the option is exercised. Therefore the date of grant for the option is the last day of the offering when the option is exercised.

Example 3. Corporation CC has an employee stock purchase plan that provides that the option price will be 85 percent of the fair market value of the stock on the last day of the offering. Options are exercised on the last day of the offering. Each offering under the plan begins on January 1 and ends on December 31 of the same calendar year. The terms of each option granted under an offering provide that the maximum number of shares that may be purchased by any employee during the offering equals \$25,000 divided by the fair market value of the stock on the first day of the offering. The maximum number of shares that can be purchased under the option is fixed and determinable on the first day of the offering and therefore the date of grant for the option is the first day of the offering.

Example 4. Assume the same facts as in *Example 3* except that the terms of each option granted under an offering provide that the maximum number of shares that may be purchased by any employee during the offering equals 10 percent of the employee's annual salary (determined as of January 1 of the year in which the offering commences) divided by the fair market value of the stock on the first day of the offering. The maximum number of shares that can be purchased under the option is fixed and determinable on the first day of the offering and therefore the date of grant for the option is the first day of the offering.

(i) *Annual \$25,000 limitation*—(1) An employee stock purchase plan must, by its terms, provide that no employee may be permitted to purchase stock under all the employee stock purchase plans of the employer corporation and its related corporations at a rate that exceeds \$25,000 in fair

market value of the stock (determined at the time the option is granted) for each calendar year in which any option granted to the employee is outstanding at any time. In applying the foregoing limitation—

(i) The right to purchase stock under an option is deemed to accrue when the option (or any portion thereof) first becomes exercisable during the calendar year;

(ii) The right to purchase stock under an option accrues at the rate provided in the option, but in no case may such rate exceed \$25,000 of fair market value of such stock (determined at the time such option is granted) for any one calendar year; and

(iii) A right to purchase stock that has accrued under one option granted pursuant to the plan may not be carried over to any other option.

(2) If an option is granted under an employee stock purchase plan that satisfies the requirement of this paragraph (i), but the option gives the optionee the right to buy stock in excess of the maximum rate allowable under this paragraph (i), then no portion of the option will be treated as having been granted under an employee stock purchase plan. Furthermore, if the option was granted to an employee entitled to the grant of an option under the terms of the plan or offering, and the employee is not granted an option under the offering that qualifies as an option granted under an employee stock purchase plan, then the offering will not meet the requirements of paragraph (e) of this section. Accordingly, none of the options granted under the offering will be eligible for the special tax treatment of section 421.

(3) The limitation of this paragraph (i) applies only to options granted under employee stock purchase plans and does not limit the amount of stock that an employee may purchase under incentive stock options (as defined in section 422(b)) or any other stock options except those to which section 423 applies. Stock purchased under options to which section 423 does not apply will not limit the amount that an employee may purchase under an employee stock purchase plan, except for purposes of the 5-percent stock ownership provision of paragraph (d) of this section.

(4) Under the limitation of this paragraph (i), an employee may purchase up to \$25,000 of stock (based on the fair market value of the stock at the time the option was granted) in each calendar year

during which an option granted to the employee under an employee stock purchase plan is outstanding and exercisable. Alternatively, an employee may purchase more than \$25,000 of stock (based on the fair market value of such stock at the time the option was granted) in a calendar year, so long as the total amount of stock that the employee purchases does not exceed \$25,000 in fair market value of the stock (determined at the time the option was granted) for each calendar year in which the option was outstanding and exercisable. If, in any calendar year, the employee holds two or more outstanding and exercisable options granted under employee stock purchase plans of the employer corporation, or a related corporation, then the employee's purchases of stock attributable to that year under all options granted under employee stock purchase plans must not exceed \$25,000 in fair market value of the stock (determined at the time the options were granted). Under an employee stock purchase plan, an employee may not purchase stock in anticipation that the option will be outstanding and exercisable in some future year. Thus, the employee may purchase only the amount of stock that does not exceed the limitation of this paragraph (i) for the year of the purchase and for preceding years during which the option was outstanding and exercisable. Thus, the amount of stock that may be purchased under an option depends on the number of years in which the option is actually outstanding and exercisable. The amount of stock that may be purchased under an employee stock purchase plan may not be increased by reason of the failure to grant an option in an earlier year under such plan, or by reason of the failure to exercise an earlier option. For example, if an option is granted to an individual and expires without having been exercised at all, then the failure to exercise the option does not increase the amount of stock which such individual may be permitted to purchase under an option granted in a year following the year of such expiration. If an option granted under an employee stock purchase plan is outstanding and exercisable in more than one calendar year, then stock purchased pursuant to the exercise of such an option will be applied first, to the extent allowable under this paragraph (i), against the \$25,000 limitation for the earliest year in which the op-

tion was outstanding and exercisable, then, against the \$25,000 limitation for each succeeding year, in order.

(5) *Examples.* The following examples illustrate the principles of this paragraph (i):

Example 1. Assume that Corporation DD maintains an employee stock purchase plan and that Employee S is employed by DD. On June 1, 2010, DD grants S an option under the plan to purchase a total of 750 shares of DD stock at \$85 per share. On that date, the fair market value of DD stock is \$100 per share. The option provides that it may be exercised at any time but cannot be exercised after May 31, 2012. Under this paragraph (i), the option must not permit S to purchase more than 250 shares of DD stock during the calendar year 2010, because 250 shares are equal to \$25,000 in fair market value of DD stock determined at the time of grant. During the calendar year 2011, S may purchase under the option an amount of DD stock equal to the difference between \$50,000 in fair market value of DD stock (determined at the time the option was granted) and the fair market value of DD stock (determined at the time of grant of the option) purchased during the year 2010. During the calendar year 2012, S may purchase an amount of DD stock equal to the difference between \$75,000 in fair market value of the stock (determined at the time of grant of the option) and the total amount of the fair market value of the stock (determined at the time of grant of the option) purchased under the option during the calendar years 2010 and 2011. S may purchase \$25,000 of stock for the year 2010, and \$25,000 of stock for the year 2012, although the option was outstanding and exercisable for only a part of each of such years. However, S may not be granted another option under an employee stock purchase plan of DD or a related corporation to purchase stock of DD or a related corporation during the calendar years 2010, 2011, and 2012, so long as the option granted June 1, 2010, is outstanding.

Example 2. Assume the same facts as in *Example 1*, except that the option granted to S in 2010 is terminated in 2011 without any part of the option having been exercised, and that subsequent to the termination and during 2011, S is granted another option under DD's employee stock purchase plan. Under that option, S may be permitted to purchase \$25,000 of stock for 2011. The failure of S to exercise the option granted to S in 2010, does not increase the amount of stock that S may be permitted to purchase under the option granted to S in 2011.

Example 3. Assume the same facts as in *Example 1*, except that, on May 31, 2012, S exercised the option granted to S in 2010, and purchased 600 shares of DD stock. Five hundred shares, the maximum amount of stock that could have been purchased in 2011, under the option, are treated as having been purchased for the years 2010 and 2011. Only 100 shares of the stock are treated as having been purchased for 2012. After S's exercise of the option on May 31, 2012, S is granted another option under DD's employee stock purchase plan. S may be permitted under the new option to purchase for 2012 stock having a fair market value of no more than \$15,000 at the time the new option is granted.

Example 4. Corporation EE maintains an employee stock purchase plan and Employee R is em-

ployed by EE. On August 1, 2010, EE grants R an option under the plan to purchase 150 shares of EE stock at \$85 per share during each of the calendar years 2010, 2011, and 2012. On that date, the fair market value of EE stock is \$100 per share. The option provides that it may be exercised at any time during years 2010, 2011, and 2012. Because this option permits R to purchase only \$15,000 of EE's stock for each year the option is outstanding and exercisable, R could be granted another option by EE, or by a related corporation, in year 2010, permitting R to purchase an additional \$10,000 of stock during each of the calendar years 2010, 2011, and 2012.

Example 5. Corporation FF maintains an employee stock purchase plan and Employee Q is employed by FF. On September 1, 2010, FF grants Q an option under the plan that will be automatically exercised on August 31, 2011, and August 31, 2012. On August 31, 2011, Q may purchase under the option an amount of FF stock equal to \$25,000 in fair market value of FF stock (determined at the time the option was granted). On August 31, 2012, Q may purchase under the option an amount of FF stock equal to the difference between \$50,000 in fair market value of Q stock (determined at the time the option was granted) and the fair market value of Q stock (determined at the time of grant of the option) purchased during year 2011.

(j) *Restriction on transferability.* An employee stock purchase plan must, by its terms, provide that options granted under the plan are not transferable by the optionee other than by will or the laws of descent and distribution, and must be exercisable, during the optionee's lifetime, only by the optionee. For general rules relating to the restriction on transferability required by this paragraph (j), see paragraph (b)(2) of §1.421-1. For a limited exception to the requirement of this paragraph (j), see section 424(h)(3).

(k) *Special rule where option price is between 85 percent and 100 percent of value of stock—(1)(i)* If all the conditions necessary for the application of section 421(a) exist, this paragraph (k) provides additional rules that are applicable in cases where, at the time the option is granted, the option price per share is less than 100 percent (but not less than 85 percent) of the fair market value of the share. In that case, upon the disposition of the share by the employee after the expiration of the two-year and the one-year holding periods, or upon the employee's death while owning the share (whether occurring before or after the expiration of such periods), there shall be included in the employee's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) the lesser of—

(A) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time the option was granted, or

(B) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time of such disposition or death.

(ii) For purposes of applying the rules of this paragraph (k), if the option price is not fixed or determinable at the time the option is granted, the option price will be computed as if the option had been exercised at such time. The amount of compensation resulting from the application of this paragraph (k) shall be included in the employee's gross income for the taxable year in which the disposition occurs, or for the taxable year closing with the employee's death, whichever event results in the application of this paragraph (k).

(iii) The application of the special rules provided in this paragraph (k) shall not affect the rules provided in section 421(a) with respect to the employee exercising the option, the employer corporation, or a related corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an employee, as provided in this paragraph (k), no income results to the employee at the time the stock is transferred to the employee, and no deduction under section 162 is allowable at any time to the employer corporation or a related corporation with respect to such amount.

(iv) If, during the employee's lifetime, the employee exercises an option granted under an employee stock purchase plan, but the employee dies before the stock is transferred to the employee pursuant to the exercise of the option, then the transfer of the stock to the employee's executor, administrator, heir, or legatee is deemed, for the purpose of sections 421 and 423, to be a transfer of the stock to the employee exercising the option and a further transfer by reason of death from the employee to the employee's executor, administrator, heir, or legatee.

(2) If the special rules provided in this paragraph (k) are applicable to the disposition of a share of stock by an employee, then the basis of the share in the employee's hands at the time of the disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in

the employee's gross income under this paragraph (k). However, the basis of a share of stock acquired after the death of an employee by the exercise of an option granted to the employee under an employee stock purchase plan shall be determined in accordance with the rules of section 421(c) and paragraph (c) of § 1.421-2. If the special rules provided in this paragraph (k) are applicable to a share of stock upon the death of an employee, then the basis of the share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in the decedent's gross income under this paragraph (k). See *Example (9)* of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) *Examples.* The following examples illustrate the principles of this paragraph (k):

Example 1. On June 1, 2010, the Corporation GG grants to Employee P, an employee of GG, an option under GG's employee stock purchase plan to purchase a share of GG stock for \$85. The fair market value of GG stock on such date is \$100 per share. On June 1, 2011, P exercises the option and on that date GG transfers the share of stock to P. On January 1, 2013, P sells the share for \$150, its fair market value on that date. P's income tax return is filed on the basis of the calendar year. The income tax consequences to P and GG are as follows—

(i) Compensation in the amount of \$15 is includible in P's gross income for the year 2013, the year of the disposition of the share. The \$15 represents the difference between the option price (\$85) and the fair market value of the share on the date the option was granted (\$100), because the value is less than the fair market value of the share on the date of disposition (\$150). For the purpose of computing P's gain or loss on the sale of the share, P's cost basis of \$85 is increased by \$15, the amount includible in P's gross income as compensation. Thus, P's basis for the share is \$100. Because the share was sold for \$150, P realizes a gain of \$50, which is treated as long-term capital gain; and

(ii) GG is not entitled to any deduction under section 162 at any time with respect to the share transferred to P.

Example 2. Assume the same facts as in *Example 1*, except that P sells the share of GG stock on January 1, 2014, for \$75, its fair market value on that date. Because \$75 is less than the option price (\$85), no amount in respect of the sale is includible as compensation in P's gross income for the year 2014. P's basis for determining gain or loss on the sale is \$85. Because P sold the share for \$75, P realized a loss of \$10 on the sale that is treated as a long-term capital loss.

Example 3. Assume the same facts as in *Example 1*, except that the option provides that the option price shall be 90 percent of the fair market value of the stock on the day the option is exercised. On June 1, 2011, when the option is exercised, the fair market value of the stock is \$120 per share so that P pays \$108 for the share of the stock. Compensation in the amount of \$10 is includible in P's gross income for the year 2013, the year of the disposition of the share. This is determined in the following manner: the excess of the fair market value of the stock at the time of the disposition (\$150) over the price paid for the share (\$108) is \$42; and the excess of the fair market value of the stock at the time the option was granted (\$100) over the option price, computed as if the option had been exercised at such time (\$90), is \$10. Accordingly, \$10, the lesser, is includible in gross income. In this situation, P's cost basis of \$108 is increased by \$10, the amount includible in P's gross income as compensation. Thus, P's basis for the share is \$118. Because the share was sold for \$150, P realizes a gain of \$32 that is treated as long-term capital gain.

Example 4. Assume the same facts as in *Example 1*, except that the option provides that the option price shall be the lesser of 95 percent of the fair market value of the stock on the first day of the offering period and 95 percent of the fair market value of the stock on the day the option is exercised. On June 1, 2011, when the option is exercised, the fair market value of the stock is \$120 per share. P pays \$95 for the share of the stock. Compensation in the amount of \$5 is includible in P's gross income for the year 2013, the year of the disposition of the share. This is determined in the following manner: the excess of the fair market value of the stock at the time of the disposition (\$150) over the price paid for the share (\$95) is \$55; and the excess of the fair market value of the stock at the time the option was granted (\$100) over the option price, computed as if the option had been exercised at such time (\$95), is \$5. Accordingly, \$5, the lesser, is includible in gross income. In this situation, P's cost basis of \$95 is increased by \$5, the amount includible in P's gross income as compensation. Thus, P's basis for the share is \$100. Because the share was sold for \$150, P realizes a gain of \$50 that is treated as long-term capital gain.

Example 5. Assume the same facts as in *Example 1*, except that instead of selling the share on January 1, 2013, P makes a gift of the share on that day. In that case \$15 is includible as compensation in P's gross income for 2013. P's cost basis of \$85 is increased by \$15, the amount includible in P's gross income as compensation. Thus, P's basis for the share is \$100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example 6. Assume the same facts as in *Example 2*, except that instead of selling the share on January 1, 2014, P makes a gift of the share on that date. Because the fair market value of the share on that day (\$75) is less than the option price (\$85), no amount in respect of the disposition by way of gift is includible as compensation in P's gross income for 2014. P's basis for the share is \$85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is \$75 (fair market value of the share at the date of gift).

Example 7. Assume the same facts as in *Example 1*, except that after acquiring the share of stock on June 1, 2011, P dies on August 1, 2012, at which time the share has a fair market value of \$150. Compensation in the amount of \$15 is includible in P's gross income for the taxable year closing with P's death, \$15 being the difference between the option price (\$85) and the fair market value of the share when the option was granted (\$100), because such value is less than the fair market value at date of death (\$150). The basis of the share in the hands of P's estate is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

Example 8. Assume the same facts as in *Example 7*, except that P dies on August 1, 2011, at which time the share has a fair market value of \$150. Although P's death occurred within six months after the transfer of the share to P, the income tax consequences are the same as in *Example 7*.

Example 9. Assume the same facts as in *Example 1*, except that the share of stock was issued in the names of P and P's spouse jointly with right of survivorship, and that P and P's spouse sold the share on June 15, 2012, for \$150, its fair market value on that

date. Compensation in the amount of \$15 is includible in P's gross income for the year 2012, the year of the disposition of the share. The basis of the share in the hands of P and P's spouse for the purpose of determining gain or loss on the sale is \$100, that is, the cost of \$85 increased by the amount of \$15 includible as compensation in P's gross income. The gain of \$50 on the sale is treated as long-term capital gain, and is divided equally between P and P's spouse.

Example 10. Assume the same facts as in *Example 1*, except that the share of stock was issued in the names of P and P's spouse jointly with right of survivorship, and that P predeceased P's spouse on August 1, 2012, at which time the share had a fair market value of \$150. Compensation in the amount of \$15 is includible in P's gross income for the taxable year closing with his death. See *Example 7*. The basis of the share in the hands of P's spouse as survivor is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

Example 11. Assume the same facts as in *Example 10*, except that P's spouse predeceased P on July 1, 2012. Section 423(c) does not apply in respect of the death of P's spouse. Upon the subsequent death

of P on August 1, 2012, the income tax consequences in respect of P's taxable year closing with the date of P's death, and in respect of the basis of the share in the hands of P's estate, are the same as in *Example 7*. If P had sold the share on July 15, 2012 (after the death of P's spouse), for \$150, its fair market value at that time, the income tax consequences would be the same as in *Example 1*.

(1) *Effective/applicability date.* Upon the date of publication of the Treasury decision adopting the rules of this section as a final regulation in the **Federal Register**, these rules will apply as of January 1, 2010.

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

(Filed by the Office of the Federal Register on July 28, 2008, 8:45 a.m., and published in the issue of the Federal Register for July 29, 2008, 73 FR. 43875)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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

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

Numerical Finding List¹

Bulletins 2008–27 through 2008–39

Announcements:

2008-62, 2008-27 I.R.B. 74
2008-63, 2008-28 I.R.B. 114
2008-64, 2008-28 I.R.B. 114
2008-65, 2008-31 I.R.B. 279
2008-66, 2008-29 I.R.B. 164
2008-67, 2008-29 I.R.B. 164
2008-68, 2008-30 I.R.B. 244
2008-69, 2008-32 I.R.B. 318
2008-70, 2008-32 I.R.B. 318
2008-71, 2008-32 I.R.B. 321
2008-72, 2008-32 I.R.B. 321
2008-73, 2008-33 I.R.B. 391
2008-74, 2008-33 I.R.B. 392
2008-75, 2008-33 I.R.B. 392
2008-76, 2008-33 I.R.B. 393
2008-77, 2008-33 I.R.B. 394
2008-78, 2008-34 I.R.B. 453
2008-79, 2008-35 I.R.B. 568
2008-80, 2008-37 I.R.B. 706
2008-81, 2008-37 I.R.B. 706
2008-82, 2008-37 I.R.B. 708
2008-83, 2008-37 I.R.B. 709
2008-84, 2008-38 I.R.B. 748
2008-85, 2008-38 I.R.B. 749

Notices:

2008-55, 2008-27 I.R.B. 11
2008-56, 2008-28 I.R.B. 79
2008-57, 2008-28 I.R.B. 80
2008-58, 2008-28 I.R.B. 81
2008-59, 2008-29 I.R.B. 123
2008-60, 2008-30 I.R.B. 178
2008-61, 2008-30 I.R.B. 180
2008-62, 2008-29 I.R.B. 130
2008-63, 2008-31 I.R.B. 261
2008-64, 2008-31 I.R.B. 268
2008-65, 2008-30 I.R.B. 182
2008-66, 2008-31 I.R.B. 270
2008-67, 2008-32 I.R.B. 307
2008-68, 2008-34 I.R.B. 418
2008-69, 2008-34 I.R.B. 419
2008-70, 2008-36 I.R.B. 575
2008-71, 2008-35 I.R.B. 462
2008-73, 2008-38 I.R.B. 717
2008-74, 2008-38 I.R.B. 718
2008-75, 2008-38 I.R.B. 719
2008-76, 2008-39 I.R.B. 768

Proposed Regulations:

REG-161695-04, 2008-37 I.R.B. 699
REG-164965-04, 2008-34 I.R.B. 450

Proposed Regulations— Continued:

REG-143453-05, 2008-32 I.R.B. 310
REG-146895-05, 2008-37 I.R.B. 700
REG-155087-05, 2008-38 I.R.B. 726
REG-142680-06, 2008-35 I.R.B. 565
REG-120476-07, 2008-36 I.R.B. 679
REG-120844-07, 2008-39 I.R.B. 770
REG-129243-07, 2008-27 I.R.B. 32
REG-138355-07, 2008-32 I.R.B. 311
REG-142040-07, 2008-34 I.R.B. 451
REG-149405-07, 2008-27 I.R.B. 73
REG-100464-08, 2008-32 I.R.B. 313
REG-101258-08, 2008-28 I.R.B. 111
REG-102122-08, 2008-31 I.R.B. 278
REG-102822-08, 2008-38 I.R.B. 744
REG-103146-08, 2008-37 I.R.B. 701
REG-106251-08, 2008-39 I.R.B. 774
REG-115457-08, 2008-33 I.R.B. 390
REG-121698-08, 2008-29 I.R.B. 163

Revenue Procedures:

2008-32, 2008-28 I.R.B. 82
2008-33, 2008-28 I.R.B. 93
2008-34, 2008-27 I.R.B. 13
2008-35, 2008-29 I.R.B. 132
2008-36, 2008-33 I.R.B. 340
2008-37, 2008-29 I.R.B. 137
2008-38, 2008-29 I.R.B. 139
2008-39, 2008-29 I.R.B. 143
2008-40, 2008-29 I.R.B. 151
2008-41, 2008-29 I.R.B. 155
2008-42, 2008-29 I.R.B. 160
2008-43, 2008-30 I.R.B. 186
2008-44, 2008-30 I.R.B. 187
2008-45, 2008-30 I.R.B. 224
2008-46, 2008-30 I.R.B. 238
2008-47, 2008-31 I.R.B. 272
2008-48, 2008-36 I.R.B. 586
2008-49, 2008-34 I.R.B. 423
2008-50, 2008-35 I.R.B. 464
2008-51, 2008-35 I.R.B. 562
2008-52, 2008-36 I.R.B. 587
2008-53, 2008-36 I.R.B. 678
2008-54, 2008-38 I.R.B. 722
2008-55, 2008-39 I.R.B. 768

Revenue Rulings:

2008-32, 2008-27 I.R.B. 6
2008-33, 2008-27 I.R.B. 8
2008-34, 2008-28 I.R.B. 76
2008-35, 2008-29 I.R.B. 116
2008-36, 2008-30 I.R.B. 165
2008-37, 2008-28 I.R.B. 77
2008-38, 2008-31 I.R.B. 249
2008-39, 2008-31 I.R.B. 252
2008-40, 2008-30 I.R.B. 166

Revenue Rulings— Continued:

2008-41, 2008-30 I.R.B. 170
2008-42, 2008-30 I.R.B. 175
2008-43, 2008-31 I.R.B. 258
2008-44, 2008-32 I.R.B. 292
2008-45, 2008-34 I.R.B. 403
2008-46, 2008-36 I.R.B. 572
2008-47, 2008-39 I.R.B. 760
2008-48, 2008-38 I.R.B. 713

Treasury Decisions:

9401, 2008-27 I.R.B. 1
9402, 2008-31 I.R.B. 254
9403, 2008-32 I.R.B. 285
9404, 2008-32 I.R.B. 280
9405, 2008-32 I.R.B. 293
9406, 2008-32 I.R.B. 287
9407, 2008-33 I.R.B. 330
9408, 2008-33 I.R.B. 323
9409, 2008-29 I.R.B. 118
9410, 2008-34 I.R.B. 414
9411, 2008-34 I.R.B. 398
9412, 2008-37 I.R.B. 687
9413, 2008-34 I.R.B. 404
9414, 2008-35 I.R.B. 454
9415, 2008-36 I.R.B. 570
9417, 2008-37 I.R.B. 693
9418, 2008-38 I.R.B. 713
9420, 2008-39 I.R.B. 750
9421, 2008-39 I.R.B. 755

¹ A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2008–1 through 2008–26 is in Internal Revenue Bulletin 2008–26, dated June 30, 2008.

Finding List of Current Actions on Previously Published Items¹

Bulletins 2008–27 through 2008–39

Announcements:

2008-64

Corrected by
Ann. 2008-71, 2008-32 I.R.B. 321

2008-72

Corrected by
Ann. 2008-78, 2008-34 I.R.B. 453

Notices:

99-48

Superseded by
Rev. Proc. 2008-40, 2008-29 I.R.B. 151

2000-9

Obsoleted by
Rev. Proc. 2008-41, 2008-29 I.R.B. 155

2004-2

Amplified by
Notice 2008-59, 2008-29 I.R.B. 123

2004-50

Amplified by
Notice 2008-59, 2008-29 I.R.B. 123

2006-88

Modified and superseded by
Notice 2008-60, 2008-30 I.R.B. 178

2007-22

Amplified by
Notice 2008-59, 2008-29 I.R.B. 123

2007-36

Clarified, modified, and amplified by
Rev. Proc. 2008-54, 2008-38 I.R.B. 722

Proposed Regulations:

REG-129243-07

Corrected by
Ann. 2008-75, 2008-33 I.R.B. 392

REG-151135-07

Hearing scheduled by
Ann. 2008-64, 2008-28 I.R.B. 114

REG-101258-08

Corrected by
Ann. 2008-73, 2008-33 I.R.B. 391

Revenue Procedures:

92-25

Superseded by
Rev. Proc. 2008-41, 2008-29 I.R.B. 155

92-83

Obsoleted by
Rev. Proc. 2008-37, 2008-29 I.R.B. 137

Revenue Procedures— Continued:

2001-10

Section 6.02(1)(a) modified and amplified by
Rev. Proc. 2008-52, 2008-36 I.R.B. 587

2001-42

Superseded by
Rev. Proc. 2008-39, 2008-29 I.R.B. 143

2002-9

Clarified, modified, amplified, and superseded by
Rev. Proc. 2008-52, 2008-36 I.R.B. 587
Modified and amplified by
Rev. Proc. 2008-43, 2008-30 I.R.B. 186

2002-28

Section 7.02(1)(a) modified and amplified by
Rev. Proc. 2008-52, 2008-36 I.R.B. 587

2002-64

Superseded by
Rev. Proc. 2008-55, 2008-39 I.R.B. 768

2005-29

Superseded by
Rev. Proc. 2008-49, 2008-34 I.R.B. 423

2006-27

Modified and superseded by
Rev. Proc. 2008-50, 2008-35 I.R.B. 464

2006-29

Superseded by
Rev. Proc. 2008-34, 2008-27 I.R.B. 13

2006-34

Superseded by
Rev. Proc. 2008-44, 2008-30 I.R.B. 187

2007-14

Superseded by
Rev. Proc. 2008-52, 2008-36 I.R.B. 587

2007-19

Superseded by
Rev. Proc. 2008-39, 2008-29 I.R.B. 143

2007-42

Superseded by
Rev. Proc. 2008-32, 2008-28 I.R.B. 82

2007-43

Superseded by
Rev. Proc. 2008-33, 2008-28 I.R.B. 93

2007-49

Section 3 modified and superseded by
Rev. Proc. 2008-50, 2008-35 I.R.B. 464

2007-50

Superseded by
Rev. Proc. 2008-36, 2008-33 I.R.B. 340

2007-66

Modified and superseded by
Rev. Proc. 2008-54, 2008-38 I.R.B. 722

Revenue Procedures— Continued:

2007-70

Modified by
Ann. 2008-63, 2008-28 I.R.B. 114

2007-72

Amplified and superseded by
Rev. Proc. 2008-47, 2008-31 I.R.B. 272

2008-12

Modified and superseded by
Rev. Proc. 2008-35, 2008-29 I.R.B. 132

2008-43

Modified by
Rev. Proc. 2008-52, 2008-36 I.R.B. 587

2008-52

Modified by
Ann. 2008-84, 2008-38 I.R.B. 748

Revenue Rulings:

67-213

Amplified by
Rev. Rul. 2008-40, 2008-30 I.R.B. 166

71-234

Modified by
Rev. Proc. 2008-43, 2008-30 I.R.B. 186

76-273

Obsoleted by
T.D. 9414, 2008-35 I.R.B. 454

77-480

Modified by
Rev. Proc. 2008-43, 2008-30 I.R.B. 186

82-105

Obsoleted by
T.D. 9414, 2008-35 I.R.B. 454

91-17

Amplified by
Rev. Proc. 2008-41, 2008-29 I.R.B. 155
Rev. Proc. 2008-42, 2008-29 I.R.B. 160
Superseded in part by
Rev. Proc. 2008-40, 2008-29 I.R.B. 151

2005-6

Amplified by
Rev. Proc. 2008-38, 2008-29 I.R.B. 139

2006-57

Modified by
Notice 2008-74, 2008-38 I.R.B. 718

2008-12

Amplified by
Rev. Rul. 2008-38, 2008-31 I.R.B. 249
Clarified by
Ann. 2008-65, 2008-31 I.R.B. 279

¹ A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2008–1 through 2008–26 is in Internal Revenue Bulletin 2008–26, dated June 30, 2008.

Treasury Decisions:

9391

Corrected by

Ann. 2008-74, 2008-33 I.R.B. 392

INDEX

Internal Revenue Bulletins 2008–27 through 2008–39

The abbreviation and number in parenthesis following the index entry refer to the specific item; numbers in roman and italic type following the parenthesis refers to the Internal Revenue Bulletin in which the item may be found and the page number on which it appears.

Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

EMPLOYEE PLANS

- Accrual rule for defined benefit plans under section 411(b)(1)(B), application (REG–100464–08) 32, 313
- Application of section 457(f) to certain arrangements regarding part-year compensation (Notice 62) 29, 130
- Closing agreements, Employee Plans Compliance Resolution System (EPCRS) (RP 50) 35, 464
- Definition of “outside director” (RR 32) 27, 6
- Employee stock purchase plans, rules (REG–106251–08) 39, 774
- Full funding limitations, weighted average interest rates, segment rates for:
 - July 2008 (Notice 65) 30, 182
 - August 2008 (Notice 69) 34, 419
 - September 2008 (Notice 75) 38, 719
- Individual Retirement Accounts (IRAs), converting amounts to Roth IRAs (TD 9418) 38, 713
- Multemployer plan funding guidance, hearing scheduled for REG–151135–07 (Ann 64) 28, 114; correction (Ann 71) 32, 321
- Proposed Regulations:
 - 26 CFR 1.401(a)(9)–1, –6, amended; 1.403(b)–6, amended; reasonable good faith interpretation of required minimum distribution rules by governmental plans (REG–142040–07) 34, 451
 - 26 CFR 1.411(b)–1, amended; accrual rules for defined benefit plans (REG–100464–08) 32, 313
 - 26 CFR 1.421–1, amended; 1.422–2, –5, amended; 1.423–1, –2, revised; employee stock purchase plans under section 423 (REG–106251–08) 39, 774
 - 26 CFR 1.432; multiemployer plan funding guidance, hearing scheduled for REG–151135–07 (Ann 64) 28, 114; correction (Ann 71) 32, 321

EMPLOYEE PLANS—Cont.

- 26 CFR 1.6039–1, revised; 1.6039–2, added; information reporting requirements under section 6039 (REG–103146–08) 37, 701
- 26 CFR 1.6060–1, amended; 1.6107–1, revised; 1.6109–2, amended; 1.6694–0, –1, –2, revised; 1.6694–3, –4, amended; 1.6695–1, revised; 1.6695–2, amended; 1.6696–1, revised; 301.7701–15, amended; tax return preparer penalties under sections 6694 and 6695 (REG–129243–07) 27, 32
- Regulations:
 - 26 CFR 1.408A–4, amended; 1.408–4T, removed; converting an IRA annuity to a Roth IRA (TD 9418) 38, 713
- Qualified retirement plans, qualification, plan sponsorship (RR 45) 34, 403
- Reasonable good faith interpretation of required minimum distribution rules by governmental plans (REG–142040–07) 34, 451
- Stocks, information reporting requirements for statutory stock options (REG–103146–08) 37, 701
- Tax return preparer penalties under sections 6694 and 6695 (REG–129243–07) 27, 32
- Transition relief, funding, expanding availability (Notice 73) 38, 717
- Trusts, qualification, Puerto Rico (RR 40) 30, 166

EMPLOYMENT TAX

- Interest-free adjustments and claims for refund of employment taxes (TD 9405) 32, 293
- Proposed Regulations:
 - 31.6060–1, added; 31.6107–1, added; 31.6109–2, added; 31.6694–1 thru –4, added; 31.6695–1, added; 31.6696–1, added; 31.7701–1, added; tax return preparer penalties under sections 6694 and 6695 (REG–129243–07) 27, 32
- Publications:
 - 1141, General Rules and Specifications for Substitute Forms W-2 and W-3, revised (RP 33) 28, 93
 - 4436, General Rules and Specifications for Substitute Form 941 and Schedule B (Form 941), revised (RP 32) 28, 82
- Regulations:
 - 26 CFR 31.6011(a)–1, –4, –5, amended; 31.6205–1, amended; 31.6302–0, –1, amended; 31.6402(a)–1, –2, amended; 31.6413(a)–1, –2, amended; 31.6414–1, amended; 602.101, amended; employment tax adjustments (TD 9405) 32, 293
- Substitute forms:
 - W-2 and W-3, general rules and specifications (RP 33) 28, 93
 - 941 and Schedule B (Form 941), general rules and specifications (RP 32) 28, 82
- Tax return preparer penalties under sections 6694 and 6695 (REG–129243–07) 27, 32

ESTATE TAX

Charitable lead unitrust (CLUT):

Inter vivos, sample forms (RP 45) 30, 225

Testamentary, sample form (RP 46) 30, 238

Interest rates for 2008, farm real property, special use value (RR 44) 32, 292

Proposed Regulations:

20.6060-1, added; 20.6107-1, added; 20.6109-1, added; 20.6694-1 thru -4, added; 20.6695-1, added; 20.6696-1, added; 20.7701-1, added; tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32

Regulations:

26 CFR 20.2036-1, amended; 20.2039-1, amended; grantor retained interest trusts, application of sections 2036 and 2039 (TD 9414) 35, 454

26 CFR 26.2600-1, amended; 26.2642-6, amended; 26.2654-1, amended; severance of a trust for generation-skipping transfer (GST) tax purposes (TD 9421) 39, 755

Tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32

Transfer tax valuation of interest in a restricted management account (RMA) (RR 35) 29, 116

Trusts:

Grantor retained interest trusts, application of sections 2036 and 2039 (TD 9414) 35, 454

Private trust company (Notice 63) 31, 261

Severance of a trust for GST tax purposes (TD 9421) 39, 755

EXCISE TAX

Charitable remainder trusts (CRTs), division into two or more separate and equal CRTs (RR 41) 30, 170

Credits, alcohol fuel, biodiesel, alternative fuel (REG-155087-05) 38, 726

Health Savings Accounts (HSAs), employer comparable contributions to HSAs under section 4980G and excise tax under sections 4980B, 4980D, 4980E, and 4980G (REG-120476-07) 36, 680

Proposed Regulations:

26 CFR 1.40-1, revised; 1.40-2, added; 1.40A-1, added; 40.0-1, amended; 40.6302(c)-1, amended; 48.0-1, amended; 48.0-4, added; 48.4041-0, amended; 48.4041-18, -20, removed and reserved; 48.4041-19, revised; 48.4081-1, -2, -3, amended; 48.4081-6, removed and reserved; 48.4082-4, amended; 48.4101-1, amended; 48.6426-1 thru -7, added; 48.6427-8, amended; 48.6427-12, added; alcohol fuel and biodiesel, renewable diesel, alternative fuel, diesel-water fuel emulsion, taxable fuel definitions, excise tax returns (REG-155087-05) 38, 726

26 CFR 54.4980B-0, B-2, G-1, G-3, G-4, amended; 54.4980D-1, E-1, G-6, G-7, added; employer comparable contributions to health savings accounts under section 4980G, and requirement of return for filing the

EXCISE TAX—Cont.

excise tax under section 4980B, 4980D, 4980E or 4980G (REG-120476-07) 36, 680

40.6060-1, added; 40.6107-1, added; 40.6109-1, added; 40.6694-1 thru -4, added; 40.6695-1, added; 40.6696-1, added; 40.7701-1, added; 41.6060-1, added; 41.6107-1, added; 41.6109-2, added; 41.6694-1 thru -4, added; 41.6695-1, added; 41.6696-1, added; 41.7701-1, added; 44.6060-1, added; 44.6107-1, added; 44.6109-1, added; 44.6694-1 thru -4, added; 44.6695-1, added; 44.6696-1, added; 44.7701-1, added; 53.6060-1, added; 53.6107-1, added; 53.6109-1, added; 53.6694-1 thru -4, added; 53.6695-1, added; 53.6696-1, added; 53.7701-1, added; 54.6060-1, added; 54.6107-1, added; 54.6109-1, added; 54.6694-1 thru -4, added; 54.6695-1, added; 54.6696-1, added; 54.7701-1, added; 55.6060-1, added; 55.6107-1, added; 55.6109-1, added; 55.6694-1 thru -4, added; 55.6695-1, added; 55.6696-1, added; 55.7701-1, added; 56.6060-1, added; 56.6107-1, added; 56.6109-1, added; 56.6694-1 thru -4, added; 56.6695-1, added; 56.6696-1, added; 56.7701-1, added; 156.6060-1, added; 156.6107-1, added; 156.6109-1, added; 156.6694-1 thru -4, added; 156.6695-1, added; 156.6696-1, added; 156.7701-1, added; 157.6060-1, added; 157.6107-1, added; 157.6109-1, added; 157.6694-1 thru -4, added; 157.6695-1, added; 157.6696-1, added; 157.7701-1, added; 301.7701-15, amended; tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32

Tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32

EXEMPT ORGANIZATIONS

Declaratory judgment suits (Ann 67) 29, 164; (Ann 72) 32, 321; correction (Ann 78) 34, 453; (Ann 82) 37, 708; (Ann 85) 38, 749

Indian tribal governments treated as states (RP 55) 39, 768

List of organizations classified as private foundations (Ann 70) 32, 318; (Ann 81) 37, 706

Proposed Regulations:

26 CFR 1.6060-1, amended; 1.6107-1, revised; 1.6109-2, amended; 1.6694-0, -1, -2, revised; 1.6694-3, -4, amended; 1.6695-1, revised; 1.6695-2, amended; 1.6696-1, revised; 301.7701-15, amended; tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32

Regulations

26 CFR 1.664-1, amended; 602.101, amended; guidance under section 664 regarding the effect of unrelated business taxable income on charitable remainder trusts (TD 9403) 32, 285

Revocations (Ann 62) 27, 74; (Ann 66) 29, 164; (Ann 69) 32, 318; (Ann 76) 33, 393; (Ann 79) 35, 568; (Ann 80) 37, 706

Tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32

EXEMPT ORGANIZATIONS—Cont.

Trusts:

Charitable remainder trusts (CRTs):

Calculation of excise tax on unrelated business taxable income (UBTI) (TD 9403) 32, 285

Division into two or more separate and equal CRTs (RR 41) 30, 170

GIFT TAX

Charitable lead unitrust (CLUT), inter vivos, sample forms (RP 45) 30, 225

Proposed Regulations:

25.6060-1, added; 25.6107-1, added; 25.6109-1, added; 25.6694-1 thru -4, added; 25.6695-1, added; 25.6696-1, added; 25.7701-1, added; 26.6060-1, added; 26.6107-1, added; 26.6109-1, added; 26.6694-1 thru -4, added; 26.6695-1, added; 26.6696-1, added; 26.7701-1, added; tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32

Tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32

Transfer tax valuation of interest in a restricted management account (RMA) (RR 35) 29, 116

Trust, private trust company (Notice 63) 31, 261

INCOME TAX

Accounting methods:

Automatic changes in methods of accounting (RP 52) 36, 587

Consent procedures, changes in method of accounting (Ann 84) 38, 748

Rolling average inventory (RP 43) 30, 186

Acquisitions, application of section 382 in the case of certain acquisitions made pursuant to the Housing and Economic Recovery Act of 2008 (Notice 76) 39, 768

Bonds:

Procedures for requesting a refund of arbitrage rebate and similar payments on tax-exempt bonds (RP 37) 29, 137

Solicitation of applications from qualified issuers for allocation of qualified forestry conservation bonds (QFCBs) limitation and application requirements (Notice 70) 36, 575

Bonus depreciation for the Kansas disaster area (Notice 67) 32, 307

Capital costs incurred to comply with EPA sulfur regulations (TD 9404) 32, 280; (REG-143453-05) 32, 310

Certain financing commitments and applicable high yield discount obligations (RP 51) 35, 562

Change to office to which notices of nonjudicial sale and requests for return of wrongfully levied property must be sent (TD 9410) 34, 414

Charitable lead unitrust (CLUT):

Inter vivos, sample forms (RP 45) 30, 225

Testamentary, sample form (RP 46) 30, 238

Charitable remainder trusts (CRTs), division into two or more separate and equal CRTs (RR 41) 30, 170

INCOME TAX—Cont.

Child of parents who are divorced, separated or living apart as the dependent of both parents (RP 48) 36, 586

Corporations:

Accumulated adjustments account (AAA) and key-man life insurance (RR 42) 30, 175

Section 108 reduction of tax attributes for S corporations (REG-102822-08) 38, 744

Credits:

Alcohol fuel, biodiesel, alternative fuel (REG-155087-05) 38, 726

Electricity produced from certain renewable resources, section 45 tax credit (Notice 60) 30, 178

Increasing research activities (TD 9401) 27, 1; (REG-149405-07) 27, 73

Low-income housing credit:

Emergency housing relief, Wisconsin severe storms, tornadoes, and flooding (Notice 61) 30, 180

Indiana severe storms and flooding (Notice 56) 28, 79

Iowa severe storms, tornadoes, and flooding (Notice 58) 28, 81

Missouri severe storms and flooding, disaster relief (Notice 66) 31, 270

Utility allowance, new options for estimating (TD 9420) 39, 750

Satisfactory bond, "bond factor" amounts for the period:

January through September 2008 (RR 36) 30, 165

Section 48 tax credit for qualifying fuel cell property and qualifying microturbine property (Notice 68) 34, 418

Declaratory judgment suits (Ann 67) 29, 164; (Ann 72) 32, 321; correction (Ann 78) 34, 453; (Ann 82) 37, 708; (Ann 85) 38, 749

Definition of "outside director" (RR 32) 27, 6

Dependent child of divorced or separated parents or parents who live apart (TD 9408) 33, 323

Disaster relief, China earthquake, qualified disaster (Notice 57) 28, 80

Disciplinary actions involving attorneys, certified public accountants, enrolled agents, and enrolled actuaries (Ann 68) 30, 245; (Ann 77) 33, 394; (Ann 83) 37, 709

Disclosure of taxpayer groupings for purposes of the passive activity loss provisions under section 469 (Notice 64) 31, 268

Disclosure or use of information by preparers of returns (TD 9409) 29, 118; (REG-121698-08) 29, 163

Economic Stimulus Act of 2008, bonus depreciation, section 179 expensing (RP 54) 38, 722

Election to expense certain refineries (TD 9412) 37, 687; (REG-146895-05) 37, 700

Employee stock purchase plans, rules (REG-106251-08) 39, 774

Escrow accounts used in like-kind exchanges (TD 9413) 34, 404

Expenses:

Elections regarding start-up expenditures, corporation organizational expenditures, and partnership organizational expenses (TD 9411) 34, 398; (REG-164965-04) 34, 450

Optional standard mileage rates, update (Ann 63) 28, 114

INCOME TAX—Cont.

Extension of time for filing returns (TD 9407) 33, 330;
(REG-115457-08) 33, 390

Farmer and fisherman income averaging (TD 9417) 37, 693;
(REG-161695-04) 37, 699

Forms:

1042-S, Foreign Person's U.S. Source Income Subject to
Withholding, specifications for filing electronically (RP
44) 30, 187

1096, 1098, 1099, 5498, W-2G, and 1042-S, substitute form
specifications (RP 36) 33, 340

8027, Employer's Annual Information Return of Tip Income
and Allocated Tips, specifications for filing electronically
(RP 34) 27, 13

8596, Information Return for Federal Contracts, specifica-
tions for filing electronically (RP 49) 34, 423

Guidance to tax return preparers:

Consents to disclose and consents to use tax return in-
formation in the Form 1040 series (TD 9409) 29, 118;
(REG-121698-08) 29, 163

Consents to disclose and consents to use tax return informa-
tion in the Form 1040 series, update to Rev. Proc. 2008-12
(RP 35) 29, 132

Guidance under section 956 for determining the basis of property
acquired in certain nonrecognition transactions (TD 9402) 31,
254; (REG-102122-08) 31, 278

Health Savings Accounts (HSAs), additional guidance (Notice
59) 29, 123

Insurance companies:

Effectively connected income (RP 53) 36, 678

Life insurance contracts:

Automatic waiver (RP 42) 29, 160

Closing agreement (RP 40) 29, 151

Modified endowment contracts (MECs), closing agree-
ments (RP 39) 29, 143

Qualified additional benefits (QABs), closing agreement
(RP 38) 29, 139

Variable contracts, closing agreement (RP 41) 29, 155

Interest:

Characterization of management fees paid by an upper tier
investment partnership and lower tier trader partnerships
(RR 39) 31, 252

Investment:

Federal short-term, mid-term, and long-term rates for:

July 2008 (RR 33) 27, 8

August 2008 (RR 43) 31, 258

September 2008 (RR 46) 36, 572

Rates:

Underpayments and overpayments, quarter beginning:

October 1, 2008 (RR 47) 39, 760

Treatment of interest expense attributable to indebtedness al-
locable to property held for investment described in section
163(d)(5)(A)(ii):

Investment interest deduction (RR 38) 31, 249

Trader partnership (Ann 65) 31, 279

Law school Loan Repayment Assistance Program (LRAP), ex-
clusion from gross income (RR 34) 28, 76

INCOME TAX—Cont.

Liens, return of wrongfully levied property and discharge of
liens, special rules (TD 9410) 34, 414

Life insurance:

Premiums by S corporation, effect on accumulated adjust-
ments account (AAA) (RR 42) 30, 175

Statutory reserves, meaning for multi-state taxpayers (RR 37)
28, 77

Presidentially declared disaster or terroristic or military
actions, postponement of certain tax-related deadlines
(REG-142680-06) 35, 565

Private foundations, organizations now classified as (Ann 70) 32,
318; (Ann 81) 37, 706

Proposed Regulations:

26 CFR 1.40-1, revised; 1.40-2, added; 1.40A-1,
added; 40.0-1, amended; 40.6302(c)-1, amended;
48.0-1, amended; 48.0-4, added; 48.4041-0, amended;
48.4041-18, -20, removed and reserved; 48.4041-19,
revised; 48.4081-1, -2, -3, amended; 48.4081-6, re-
moved and reserved; 48.4082-4, amended; 48.4101-1,
amended; 48.6426-1 thru -7, added; 48.6427-8, amended;
48.6427-12, added; alcohol fuel and biodiesel, renewable
diesel, alternative fuel, diesel-water fuel emulsion, taxable
fuel definitions, excise tax returns (REG-155087-05) 38,
726

26 CFR 1.41-6, -8, amended; 1.41-9, added; alternative sim-
plified credit under section 41(c)(5) (REG-149405-07) 27,
73

26 CFR 1.108-7, amended; section 108 reduction of tax at-
tributes for S corporations (REG-102822-08) 38, 744

26 CFR 1.179B-1, added; capital costs incurred to comply
with EPA sulfur regulations (REG-143453-05) 32, 310

26 CFR 1.179C-1, added; election to expense certain refin-
eries (REG-146895-05) 37, 700

26 CFR 1.195-1, revised; 1.248-1, amended; 1.709-1,
amended; elections regarding start-up expenditures, cor-
poration organizational expenditures, and partnership
organizational expenses (REG-164965-04) 34, 450

26 CFR 1.367(a)-2, -4, -5, added; 1.954-2(c), revised;
1.956-2(b), -2(e), revised, modifications to subpart
F treatment of aircraft and vessel leasing income
(REG-138355-07) 32, 311

26 CFR 1.401(a)(9)-1, -6, amended; 1.403(b)-6,
amended; reasonable good faith interpretation of re-
quired minimum distribution rules by governmental plans
(REG-142040-07) 34, 451

26 CFR 1.421-1, amended; 1.422-2, -5, amended; 1.423-1,
-2, revised; employee stock purchase plans under section
423 (REG-106251-08) 39, 774

26 CFR 1.460-3 thru -6, amended; rules for home construc-
tion contracts (REG-120844-07) 39, 770

26 CFR 1.642(c)-3, amended; 1.643(a)-5, amended; guid-
ance under sections 642 and 643 (income ordering rules)
(REG-101258-08) 28, 111; correction (Ann 73) 33, 391

26 CFR 1.956-1, amended; guidance under section 956 for
determining the basis of property acquired in certain non-
recognition transactions (REG-102122-08) 31, 278

INCOME TAX—Cont.

- 26 CFR 1.1301-1, amended; farmer and fisherman income averaging (REG-161695-04) 37, 699
- 26 CFR 1.6039-1, revised; 1.6039-2, added; information reporting requirements under section 6039 (REG-103146-08) 37, 701
- 26 CFR 1.6060-1, amended; 1.6107-1, revised; 1.6109-2, amended; 1.6694-0, -1, -2, revised; 1.6694-3, -4, amended; 1.6695-1, revised; 1.6695-2, amended; 1.6696-1, revised; 301.7701-15, amended; tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, 32; corrections (Ann 75) 33, 392
- 26 CFR 1.6081-2, -6, added; 54.6081-1, added; extension of time for filing returns (REG-115457-08) 33, 390
- 26 CFR 301.7216-3, amended; disclosure or use of information by preparers of returns (REG-121698-08) 29, 163
- 26 CFR 301.7508A-1, amended; postponement of certain tax-related deadlines by reason of Presidentially declared disaster or terroristic or military actions (REG-142680-06) 35, 565

Publications:

- 1141, General Rules and Specifications for Substitute Forms W-2 and W-3, revised (RP 33) 28, 93
- 1179, General Rules and Specifications for Substitute Forms 1096, 1098, 1099, 5498, W-2G, and 1042-S, update (RP 36) 33, 340
- 1187, Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, Electronically, revised (RP 44) 30, 187
- 1239, Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, Electronically (RP 34) 27, 13
- 1516, Specifications for Filing Form 8596, Information Return for Federal Contracts, Electronically (RP 49) 34, 423
- 4436, General Rules and Specifications for Substitute Form 941 and Schedule B (Form 941), revised (RP 32) 28, 82

Real Estate Mortgage Investment Conduit (REMIC), allocation of income to foreign persons by certain entites (TD 9415) 36, 570

Reasonable good faith interpretation of required minimum distribution rules by governmental plans (REG-142040-07) 34, 451

Regulations:

- 26 CFR 1.41-0, -1, -6, -8, amended; 1.41-0T, -6T, -8T, -9, -9T added; alternative simplified credit under section 41(c)(5) (TD 9401) 27, 1
- 26 CFR 1.42-10, -12, amended; section 42 utility allowance regulations update (TD 9420) 39, 750
- 26 CFR 1.152-4, revised; 1.152-4T, removed; dependent child of divorced or separated parents or parents who live apart (TD 9408) 33, 323
- 26 CFR 1.179B-1T, added; 602.101, amended; capital costs incurred to comply with EPA sulfur regulations (TD 9404) 32, 280
- 26 CFR 1.179C-1T, added; 602.101, amended; election to expense certain refineries (TD 9412) 37, 687

INCOME TAX—Cont.

- 26 CFR 1.195-1, revised; 1.195-1T, added; 1.248-1, amended; 1.248-1T, added; 1.709-1, amended; 1.709-1T, added; elections regarding start-up expenditures, corporation organizational expenditures, and partnership organizational expenses (TD 9411) 34, 398
 - 26 CFR 1.367(a)-2T, -4T, -5T, amended; 1.954-2, amended; 1.954-2T, added; 1.956-2, -2T, amended; modifications to subpart F treatment of aircraft and vessel leasing income (TD 9406) 32, 287
 - 26 CFR 1.468B-0, amended; 1.468B-6, added; 1.1031(k)-1, amended; 1.7872-5, -16, added; escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property (TD 9413) 34, 404
 - 26 CFR 1.664-1, amended; 602.101, amended; guidance under section 664 regarding the effect of unrelated business taxable income on charitable remainder trusts (TD 9403) 32, 285
 - 26 CFR 1.860A-0, -1, amended; 1.860A-1T, removed; 1.860G-3, amended; 1.860G-3T, removed; 1.863-0, -1, amended; 1.863-1T, removed; 1.1441-0, -2, amended; 1.1441-2T, removed; REMIC residual interests—accounting for REMIC net income (including any excess inclusions) (foreign holders) (TD 9415) 36, 570
 - 26 CFR 1.881-5T, removed; correction to TD 9391 (Ann 74) 33, 392
 - 26 CFR 1.911-7, amended; 1.6081-1, -3, -5, amended; 1.6081-2T, -6T, revised; 1.6081-3T, -4T, -5T, -7T, -10T, -11T, removed; 1.6081-4, -7, -10, -11, added; 25.6081-1, added; 25.6081-1T, removed; 26.6081-1, added; 26.6081-1T, removed; 53.6081-1, added; 53.6081-1T, removed; 55.6081-1, added; 55.6081-1T, removed; 156.6081-1, added; 156.6081-1T, removed; 157.6081-1, added; 157.6081-1T, removed; 301.6081-2, added; 301.6081-2T, removed; extension of time for filing returns (TD 9407) 33, 330
 - 26 CFR 1.956-1, -1T, amended; guidance under section 956 for determining the basis of property acquired in certain nonrecognition transactions (TD 9402) 31, 254
 - 26 CFR 1.1301-1, amended; 1.1301-1T, added; farmer and fisherman income averaging (TD 9417) 37, 693
 - 26 CFR 301.6343-2, amended; 301.6343-2T, removed; 301.7425-3, amended; 301.7425-3T, removed; change to office to which notices of nonjudicial sale and requests for return of wrongfully levied property must be sent (TD 9410) 34, 414
 - 26 CFR 301.7216-3, amended; 301.7216-3T, added; disclosure or use of information by preparers of returns (TD 9409) 29, 118
- Revocations, exempt organizations (Ann 62) 27, 74; (Ann 66) 29, 164; (Ann 69) 32, 318; (Ann 76) 33, 393; (Ann 79) 35, 568; (Ann 80) 37, 706
- Rules for certain long-term construction contracts (REG-120844-07) 39, 770
- Smartcards, debit cards, etc., used to provide qualified transportation fringes under section 132(f), delayed effective date of Rev. Rul. 2006-57 (Notice 74) 38, 718

INCOME TAX—Cont.

Standard Industry Fare Level (SIFL) formula (RR 48) 38, *713*

Stocks:

Auction rate preferred stock, regulated investment companies (RICs), debt instruments (Notice 55) 27, *11*

Information reporting requirements for statutory stock options (REG-103146-08) 37, *701*

Subprime mortgage loans, modifications held by certain securitization vehicles (RP 47) 31, *272*

Substitute forms:

W-2 and W-3, general rules and specifications (RP 33) 28, *93*
941 and Schedule B (Form 941), general rules and specifications (RP 32) 28, *82*

1096, 1098, 1099, 5498, W-2G, and 1042-S, rules and specifications (RP 36) 33, *340*

Tax return preparer penalties under sections 6694 and 6695 (REG-129243-07) 27, *32*; corrections (Ann 75) 33, *392*

Treatment of aircraft and vessel leasing income (TD 9406) 32, *287*; (REG-138355-07) 32, *311*

Trusts:

Charitable remainder trust, calculation of excise tax on unrelated business taxable income (UBTI) (TD 9403) 32, *285*

Ordering of distributions from charitable lead trusts (REG-101258-08) 28, *111*; correction (Ann 73) 33, *391*

Private trust company (Notice 63) 31, *261*

U.S. territories, American Samoa, Guam, The Northern Mariana Islands, Puerto Rico, U.S. Virgin Islands, source of income, filing requirements; correction to TD 9391 (Ann 74) 33, *392*

Valuation safe harbor under section 475 (Notice 71) 35, *462*



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