Internal Revenue bulletin

Bulletin No. 2008-24
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HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

T.D. 9398, page 1143.

Final regulations under section 704 of the Code clarify that where certain look-through entities (or members of a consolidated group) are partners in a partnership, the tax attributes of the owners of the look-through entities must be taken into account when testing whether the economic effect of an allocation is substantial within the meaning of section 704(b). Through an example, the final regulations also reiterate the effect of other provisions, such as section 482, upon the tax treatment of a partner with respect to the partner's distributive share under section 704(b).

T.D. 9400, page 1139.
REG–136020–07, page 1154.

Final, temporary, and proposed regulations under section 367 of the Code implement the rules announced in Notices 2006–85, 2006–2 C.B. 677, and 2007–48, 2007–25 I.R.B. 1428. The notices announced that Treasury and the IRS would issue regulations under section 367(b) to address transactions where either a parent corporation (P) or its subsidiary (S) (or both) are foreign, and the corporations seek to avoid treating as a distribution the amount of property that S transfers to P or P's shareholders in exchange for P stock, which S then uses to acquire the stock or assets of another corporation (T) in a triangular reorganization. Notices 2006–85 and 2007–48 obsoleted by T.D. 9400.

EXEMPT ORGANIZATIONS

Announcement 2008–54, page 1155.

The IRS has revoked its determination that Community Child Care of Portland, OR; Camp Meeting of the Assoc. of the Newark Conf. of the Methodist Episcopal Church of Mount Tabor, NJ; Berryessa PAL Youth Football Club, Inc., of San Jose, CA; Rape Survivors Anonymous World Services, Inc., of Oswego, IL; and Round Rock Band Boosters, Inc., of Round Rock, TX, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

EMPLOYMENT TAX

Rev. Rul. 2008–29, page 1149.

Supplemental wages; income tax. This ruling provides guidance with respect to income tax withholding in nine different situations involving the payment of supplemental wages. Rev. Ruls. 66–294 and 67–131 obsoleted.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

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.

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 367.—Foreign Corporations

26 CFR 1.367(b)–14T: Acquisition of parent stock for property in triangular reorganizations (temporary).

T.D. 9400

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Treatment of Property Used to Acquire Parent Stock in Certain Triangular Reorganizations Involving Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations under section 367(b) of the Internal Revenue Code (Code). The final regulations revise an existing final regulation and add a cross-reference. The temporary regulations implement the rules described in Notice 2006–85 and Notice 2007–48. The regulations affect corporations engaged in certain triangular reorganizations involving one or more foreign corporations. The text of the temporary regulations serves as the text of the proposed regulations (REG–136020–07) set forth in the notice of proposed rulemaking on this subject published in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective May 27, 2008.

Applicability Dates: For dates of applicability, see §§1.367(a)–3T(b)(2)(i)(C) and 1.367(b)–14T(e).

FOR FURTHER INFORMATION CONTACT: Daniel McCall, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 22, 2006, the IRS and Treasury Department issued Notice 2006–85, 2006–2 C.B. 677, which announced that regulations would be issued under section 367(b) to address certain triangular reorganizations under section 368(a) involving one or more foreign corporations. On May 31, 2007, the IRS and Treasury Department issued Notice 2007–48, 2007–25 I.R.B. 1428, which amplified Notice 2006–85 and announced that additional regulations would be issued under section 367(b). Each notice describes transactions the IRS and Treasury Department believe raise significant policy concerns.

Notice 2006–85 describes triangular reorganizations in which a subsidiary (S) purchases stock of its parent corporation (P) from P in exchange for property, and then exchanges the P stock for the stock or assets of a target corporation (T), but only if P or S (or both) is foreign. Notice 2006–85 announced that regulations to be issued under section 367(b) would make adjustments that would have the effect of a distribution of property from S to P under section 301 (deemed distribution). Notice 2006–85 further announced that regulations would address similar transactions where S acquires the P stock from a related party that purchased the P stock in a related transaction.

Notice 2007–48 describes transactions in which S purchases all or a portion of the P stock exchanged in the reorganization from a person other than P (such as from public shareholders on the open market). Notice 2007–48 announced that regulations to be issued under section 367(b) would also make adjustments that would have the effect of a distribution of property from S to P (under section 301) followed by a deemed contribution of such property by P to S. Notice 2007–48 further announced that the regulations would take into account the earnings and profits of other corporations, as appropriate, if a principal purpose of creating, organizing, or funding S is to avoid the adjustments to be made by the regulations.

These temporary regulations set forth the regulations described in Notices 2006–85 and 2007–48. The existing final regulations under §1.367(b)–13 are revised to conform the definitions of the terms P, S, and T in those regulations to the definitions of such terms in these temporary regulations. The existing final regulations under §1.367(b)–2 are revised to clarify that the definition of earnings and profits in §1.367(b)–2(l)(8) applies only for purposes of §§1.367(b)–7 and 1.367(b)–9.

Explanation of Provisions

A. *Section 367— In General*

Section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. However, exceptions are provided under section 367(a)(2) and (3), and the Secretary has broad authority under section 367(a)(6) to provide that section 367(a)(1) will not apply to certain transfers otherwise described therein.

Section 367(b)(1) provides that in the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to basis of stock or securities.

B. *Policies of Section 367(b)*

Section 367(b) was enacted to ensure that international tax considerations are adequately addressed when the nonrecognition provisions of subchapter C of the Code apply to certain exchanges involving foreign corporations. Congress further noted that "it is essential to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings...." H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975). Accordingly, Congress granted the Secretary authority to provide regulations "necessary or appropriate to prevent the avoidance of Federal income taxes" and identified "transfers constituting a repatriation of foreign earnings" as a type of transfer to be covered in regulations to be promulgated by the Secretary. *Id*. The Secretary has exercised this grant of authority to address a wide range of international policy concerns. For further discussion, see Notices 2006–85 and 2007–48.

C. *Adjustments Made Under Section 367(b)*

These temporary regulations apply to triangular reorganizations where P or S (or both) is foreign and, in connection with the reorganization, S acquires, in exchange for property, all or a portion of the P stock that is used to acquire the stock or assets of T. The "in connection with" standard is a broad standard that includes any transaction related to the reorganization even if the transaction is not part of the plan of reorganization. For example, the temporary regulations apply to a triangular reorganization regardless of whether P controls S (within the meaning of section 368(c)) when S acquires the P stock that is used in the reorganization.

In a triangular reorganization subject to the temporary regulations, adjustments shall be made that have the effect of a distribution of property from S to P under section 301. The amount of the deemed distribution shall equal the amount of money plus the fair market value of other property that S used to acquire P stock. For this purpose, the term property has the meaning set forth in section 317(a), but includes any liability assumed by S in exchange for the P stock (notwithstanding the application of section 357(a)) and any S stock used by S to acquire the P stock from a person other than P. Consistent with the rule announced in Notice 2007–48, these temporary regulations provide that to the extent S buys P stock from a person other than P, immediately after taking into account the deemed distribution to P, P is deemed to contribute to S the property deemed distributed to P.

These temporary regulations provide that the deemed distribution shall be treated as a distribution for all purposes of the Code. For example, provisions such as sections 312, 881, 897, 902, 959, 1442, and 1445 apply, as appropriate, to the deemed distribution. Similarly, the deemed contribution of property shall be treated as a contribution of property for all purposes of the Code. For example, appropriate adjustments to P's basis in the S stock and other affected items shall be made according to applicable Code provisions.

Ordering rules are provided that generally require the deemed distribution and, in cases where S buys P stock from a person other than P, the deemed contribution to be taken into account before the transfers undertaken pursuant to the triangular reorganization. If P does not control S (within the meaning of section 368(c)) at the time that S purchases the P stock, the deemed distribution and deemed contribution shall be treated as separate transactions occurring immediately after P acquires control of S. Thus, in a transaction where S purchases the P stock from a person other than P, after taking into account the adjustments made under these temporary regulations, S's purchase and transfer of P stock pursuant to the triangular reorganization are taken into account under generally applicable Code provisions, such as sections 304, 354, 356, 358, and 368.

These temporary regulations also provide that appropriate adjustments will be made if in connection with a triangular reorganization described in the regulations, a transaction is engaged in with a view to avoid the purpose of the regulations. For example, if S is a newly formed corporation and, in connection with the reorganization, P contributes to S another corporation with positive earnings and profits (S2) to facilitate S's purchase of the P stock or to facilitate the repayment of an obligation incurred by S to purchase the P stock, then, under the temporary regulations, the earnings and profits of S may be deemed to include the earnings and profits of S2.

Finally, these temporary regulations contain a coordination rule that applies to transactions described in section 367(a) and §1.367(b)–14T. The IRS and Treasury Department continue to study transactions that implicate the policies of section 367(a) and (b), but that are not subject to both provisions as a result of the application of the coordination rule. Comments are requested on such transactions.

Availability of IRS Documents

IRS notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Effective/Applicability Dates

With respect to those rules addressing transactions described in Notice 2006–85, these temporary regulations are generally applicable to transactions occurring on or after September 22, 2006, with limited transition relief. With respect to those rules addressing transactions described in Notice 2007–48, these temporary regulations are generally applicable to transactions occurring on or after May 31, 2007, with limited transition relief. Other rules included in these temporary regulations are generally applicable to transactions occurring on or after May 23, 2008, with limited transition relief. See §1.367(b)–14T(e).

No inference is intended as to the potential applicability of other Code or regulatory provisions or judicial doctrines (including substance over form) to transactions described in these temporary regulations.

Effect on Other Documents

The following publications are obsolete as of May 27, 2008:

Notice 2006–85, 2006–2 C.B. 677.

Notice 2007–48, 2007–25 I.R.B. 1428.

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. A delayed effective date would be inappropriate because the purpose of this regulation is to address transactions that the IRS and Treasury Department believe raise serious policy concerns. Accordingly, good cause is found for dispensing with notice and public comment pursuant to 5 U.S.C. 553(b) and (c) and with a delayed effective date pursuant to 5 U.S.C. 553(d). Furthermore, under section 7805(b)(1)(C) of the Code, an effective date earlier than the date this regulation is filed with the **Federal Register** is appropriate because prior notices substantially described the rules contained in this regulation. For applicability of the Regulatory Flexibility Act, see the cross-referenced notice of proposed rulemaking published elsewhere in this Bulletin. 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 its impact on small business.

Request for Comments

For information on how to submit comments or request a public hearing, see the section "Comments and Requests for a Public Hearing," set forth in the notice of proposed rulemaking published elsewhere in this issue of the Bulletin.

Drafting Information

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

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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 is amended by adding new entries in numerical order to read as follows:

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

Section 1.367(a)–3T(b)(2)(i)(C) also issued under 26 U.S.C. 367(a) and (b). * * *

Section 1.367(b)–14T also issued under 26 U.S.C. 367(b). * * *

Par. 2. Section 1.367(a)–3 is amended by revising the first sentence in paragraph (b)(2)(i) and adding new paragraph (b)(2)(i)(C) to read as follows:

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

* * * * *

(b) * * *

(2) * * *

(i) * * * A transfer of stock or securities described in section 367(a) or the regulations thereunder as well as in section 367(b) or the regulations thereunder shall be subject concurrently to sections 367(a) and (b) and the respective regulations thereunder, except as provided in paragraph (b)(2)(i)(A) through (C) of this section. * * *

(C) [Reserved]. For further guidance, see §1.367(a)–3T(b)(2)(i)(C).

* * * * *

Par. 3. Section 1.367(a)–3T is amended by revising paragraphs (a) through (d) and (f)(3), to read as follows:

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

(a) through (b)(2)(i)(B) [Reserved]. For further guidance, see §1.367(a)–3(a) through (b)(2)(i)(B).

(C) If in connection with a transaction described in §1.367(b)–14T, one or more U.S. persons transfer stock of T, as defined in §1.358–6(b)(1)(iii), to a corporation in a transfer described in section 367(a), and the amount of gain in the T stock that would otherwise be recognized under section 367(a) is less than the deemed distribution that would result from the adjustments made under §1.367(b)–14T and that would be treated as a dividend under section 301(c)(1), then section 367(b), and not section 367(a), shall apply to such transaction. This paragraph (b)(2)(i)(C) applies to transfers occurring on or after May 23, 2008.

(b)(2)(ii) through (d) [Reserved]. For further guidance, see §1.367(a)–3(b)(2)(ii) through (d).

* * * * *

(f) * * *

(3) *Expiration date*. The applicability of §1.367(a)–3T(b)(2)(i)(C) expires on May 23, 2011. The applicability of §1.367(a)–3T(e) and (f)(1) and (f)(2) expires on February 1, 2010.

Par. 4. Section 1.367(b)–2 is amended by revising paragraph (l)(8) to read as follows:

§1.367(b)–2 Definitions and special rules.

* * * * *

(l) * * *

(8) *Earnings and profits*. For purposes of §§1.367(b)–7 and 1.367(b)–9, the term *earnings and profits* means post-1986 undistributed earnings, pre-1987 accumulated profits, and pre-1987 section 960 earnings and profits.

* * * * *

Par. 5. Section 1.367(b)–13 is amended by redesignating paragraph (a)(2)(ii) as paragraph (a)(2)(iii), revising newly designated paragraph (a)(2)(iii), and adding a new paragraph (a)(2)(ii) to read as follows:

§1.367(b)–13 Special rules for determining basis and holding period.

(a) * * *

(2) * * *

(ii) The terms *P*, *S*, and *T* have the meanings set forth in §1.358–6(b)(1)(i), (ii), and (iii), respectively.

(iii) A triangular reorganization is a reorganization described in §1.358–6(b)(2)(i), (ii), or (iii) or in sections 368(a)(1)(G) and (a)(2)(D) (a forward triangular merger, triangular C reorganization, reverse triangular merger, or triangular G reorganization, respectively).

* * * * *

Par. 6. Section 1.367(b)–14T is added to read as follows:

§1.367(b)–14T Acquisition of parent stock for property in triangular reorganizations (temporary).

(a) *In general*—(1) *Scope and purpose*. This section applies to triangular reorganizations where P or S (or both) is foreign and, in connection with the reorganization, S acquires, in exchange for property (as defined in this section), all or a portion of the P stock that is used to acquire the stock or assets of T. This section may apply to a reorganization regardless of whether P controls S (within the meaning of section 368(c)) at the time S acquires the P stock that is used to acquire the stock or assets of T. The purpose of this section is to prevent what is in effect a distribution of property to P without the application of provisions otherwise applicable to property distributions, when in connection with a triangular reorganization S acquires, in exchange for property, all or a portion of the P stock used in the reorganization.

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

(i) The terms *P*, *S*, and *T* have the meanings set forth in §1.358–6(b)(1)(i), (ii), and (iii), respectively.

(ii) In general, the term *property* has the meaning set forth in section 317(a). Notwithstanding section 357(a), such term includes any liability assumed by S in exchange for the P stock used to acquire the stock or assets of T. Such term also includes any S stock used by S to acquire P stock from a person other than P.

(iii) The term *triangular reorganization* means a reorganization described in §1.358–6(b)(2) or in section 368(a)(1)(G) and (a)(2)(D).

(b) *General rules*—(1) *Deemed distribution*. If this section applies, adjustments shall be made that have the effect of a distribution of property from S to P under section 301 (deemed distribution). The amount of the deemed distribution shall equal the amount of money plus the fair market value of other property transferred, in connection with the reorganization, by S in exchange for the P stock used to acquire the stock or assets of T in the triangular reorganization. Additional adjustments shall be made under paragraph (b)(3) of this section to the extent S acquires, in exchange for property, P stock from a person other than P.

(2) *Timing in the case of acquisitions from P*. To the extent S acquires P stock from P in exchange for property, the deemed distribution described in paragraph (b)(1) of this section shall be treated as a transaction separate from, and occurring immediately before, the triangular reorganization. Therefore, P shall not be treated as receiving the property from S in exchange for P stock. The transfers of P stock in the triangular reorganization shall be subject to generally applicable provisions. See, for example, §1.1032–2.

(3) *Timing and deemed contribution in the case of acquisitions from persons other than P*. To the extent S acquires P stock from a person other than P in exchange for property (the purchase), then immediately following the deemed distribution described in paragraph (b)(1) of this section, adjustments shall be made that have the effect of a contribution by P to S (deemed contribution) of the property deemed distributed by S to P under paragraph (b)(1) of this section. If P controls S (within the meaning of section 368(c)) at the time of the purchase, the deemed distribution and deemed contribution shall be treated as separate transactions occurring immediately before the purchase. If P does not control S (within the meaning of section 368(c)) at the time of the purchase, the deemed distribution and deemed contribution shall be treated as separate transactions occurring immediately after P acquires control of S. Other provisions, such as sections 304, 354, 358 and 368, shall apply after the adjustments made pursuant to paragraph (b)(1) of this section and this paragraph.

(4) *Example*. The rules of this paragraph (b) are illustrated by the following example:

(i) *Facts*. P, a publicly traded domestic corporation, owns all of the outstanding stock of FS, a foreign corporation, and all of the outstanding stock of US1, a domestic corporation that is a member of the P consolidated group. US1 owns all of the outstanding stock of FT, a foreign corporation, the fair market value of which is $100x. FS purchases $100x of P stock on the open market for cash. Pursuant to foreign law, FT merges with and into FS in a triangular reorganization described in section 368(a)(1)(A) by reason of section 368(a)(2)(D). US1 exchanges all the outstanding stock of FT for the stock of P purchased by FS on the open market for $100x cash.

(ii) *Analysis*. The triangular reorganization is described in paragraph (a)(1) of this section. Therefore, pursuant to paragraphs (b)(1) and (b)(3) of this section, FS is treated as distributing $100x to P under section 301. Immediately after such deemed distribution, P is deemed to contribute to FS the $100x that was deemed distributed to P. The deemed distribution and deemed contribution are treated as separate transactions occurring immediately before FS's purchase of the P stock used in the triangular reorganization.

(c) *Collateral adjustments*. This paragraph (c) provides rules for the treatment of a deemed distribution or deemed contribution resulting under paragraph (b)(1) or (b)(3) of this section.

(1) *Deemed distribution*. A deemed distribution of property described in paragraph (b)(1) of this section shall be treated as a distribution of property for all purposes of the Internal Revenue Code. For example, under section 301(c) the distribution may constitute a dividend to the extent of the earnings and profits of S, a return of basis, or gain from the sale or exchange of property, as appropriate. In addition, sections 902 and 959 may apply when S is foreign, and sections 897, 1442, and 1445 may apply when S is domestic.

(2) *Deemed contribution*. A deemed contribution of property described in paragraph (b)(3) of this section shall be treated as a contribution of property for all purposes of the Internal Revenue Code. For example, appropriate adjustments to P's basis in the S stock and other affected items shall be made according to applicable provisions.

(d) *Special rule*. Appropriate adjustments shall be made pursuant to this section if, in connection with a triangular reorganization, a transaction is engaged in with a view to avoid the purpose of this section as described in paragraph (a)(1) of this section. For example, if S is formed or availed of with a view to avoid the purpose of this section, the earnings and profits of S may be deemed to include the earnings and profits of a corporation related to S (within the meaning of section 267(b)).

(e) *Effective/applicability date*—(1) *Acquisitions of P stock from P or related persons*. Except as otherwise provided in this paragraph (e), this section applies to triangular reorganizations described in paragraph (a)(1) of this section, to the extent S acquires the P stock from P or from a person related to P or S within the meaning of section 267(b) or 707(b), occurring on or after September 22, 2006. This section, however, shall not apply to triangular reorganizations described in paragraph (a)(1) of this section, to the extent S acquires the P stock from P or from a person related to P or S within the meaning of section 267(b) or 707(b), completed on or after September 22, 2006, pursuant to a written agreement that was (subject to customary conditions) binding before September 22, 2006, and all times afterward.

(2) *Acquisitions of P stock from persons other than P*—(i) *General rule*. Except as otherwise provided in this paragraph (e), this section applies to triangular reorganizations described in paragraph (a)(1) of this section, to the extent S acquires the P stock from a person other than P that is not

related to P or S within the meaning of section 267(b) or 707(b) (unrelated person), occurring on or after May 31, 2007.

(ii) *Binding commitment exception*. This section shall not apply to triangular reorganizations described in paragraph (a)(1) of this section, to the extent S acquires the P stock from an unrelated person, pursuant to a written agreement that was (subject to customary conditions) binding before May 31, 2007, and all times afterward, but only to the extent that—

(A) S acquired the P stock from an unrelated person before May 31, 2007; or

(B) S had a commitment to acquire the P stock from an unrelated person pursuant to a written agreement that was (subject to customary conditions) binding before May 31, 2007, and all times afterward, or pursuant to a tender offer announced before May 31, 2007, that is subject to section 14(d) of the Securities and Exchange Act of 1934 (15 U.S.C. 78n(d)(1)) and Regulation 14(D) (17 CFR 240.14d–1 through 240.14d–101) or that is subject to comparable foreign laws.

(3) *Application of special rule*—(i) *General rule*. Except as provided in paragraph (e)(3)(ii) of this section, paragraph (d) of this section applies to triangular reorganizations described in paragraph (a)(1) of this section occurring on or after May 31, 2007.

(ii) *Binding commitment exception*. Paragraph (d) of this section shall not apply to triangular reorganizations described in paragraph (a)(1) of this section entered into pursuant to a written agreement that was (subject to customary conditions) binding before May 31, 2007, and all times afterward, but only to the extent that—

(A) S acquired the P stock before May 31, 2007; or

(B) S had a commitment to acquire the P stock from an unrelated person pursuant to a written agreement that was (subject to customary conditions) binding before May 31, 2007, and all times afterward, or pursuant to a tender offer announced before May 31, 2007, that is subject to section 14(d) of the Securities and Exchange Act of 1934 (15 U.S.C. 78n(d)(1)) and Regulation 14(D) (17 CFR 240.14d–1 through 240.14d–101) or that is subject to comparable foreign laws.

(4) *Treatment of S stock as property*—(i) *General rule*. Except as provided in paragraph (e)(4)(ii) of this section, the treatment of S stock as property under paragraph (a)(2)(ii) of this section applies to triangular reorganizations described in paragraph (a)(1) of this section occurring on or after May 23, 2008.

(ii) *Binding commitment exception*. The treatment of S stock as property under paragraph (a)(2)(ii) of this section shall not apply to triangular reorganizations described in paragraph (a)(1) of this section occurring on or after May 23, 2008 entered into pursuant to a written agreement that was (subject to customary conditions) binding before May 23, 2008 and all times afterward, but only to the extent that—

(A) S acquired the P stock before May 23, 2008; or

(B) S had a commitment to acquire the P stock from an unrelated person pursuant to a written agreement that was (subject to customary conditions) binding before May 23, 2008 and all times afterward, or pursuant to a tender offer announced before May 23, 2008, that is subject to section 14(d) of the Securities and Exchange Act of 1934 (15 U.S.C. 78n(d)(1)) and Regulation 14(D) (17 CFR 240.14d–1 through 240.14d–101) or that is subject to comparable foreign laws.

(5) *Expiration*. The applicability of this section expires on May 23, 2011.

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

Approved May 16, 2008.

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

(Filed by the Office of the Federal Register on May 23, 2008, 8:45 a.m., and published in the issue of the Federal Register for May 27, 2008, 73 F.R. 30301)

Section 704.—Partner's Distributive Share

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

T.D. 9398

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Partner's Distributive Share

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing rules for testing whether the economic effect of an allocation is substantial within the meaning of section 704(b) where partners are look-through entities or members of a consolidated group. The final regulations clarify the application of section 704(b) to partnerships the interests of which are owned by look-through entities and members of consolidated groups and, through an example, reiterate the effect of other provisions of the Internal Revenue Code (Code) on partnership allocations. The final regulations affect partnerships and their partners.

DATES: *Effective Date:* The final regulations are effective on May 19, 2008.

Applicability Date: The final regulations apply to partnership taxable years beginning on or after May 19, 2008.

FOR FURTHER INFORMATION CONTACT: Jonathan E. Cornwell and Kevin I. Babitz at (202) 622–3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 704 of the Internal Revenue Code (Code). On November 18, 2005, proposed regulations (REG–144620–04, 2005–2 C.B. 1141) regarding the substantiality of allocations to partners that are look-through entities or members of a consolidated group were published in the **Federal Register** (70 FR 69919). Because no requests to speak were submitted by January 25, 2006, no public hearing was held (see 71 FR 7453). The IRS did receive a number of written comments responding to the proposed regulations, and, after consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

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

In order for an allocation to have substantial economic effect, it must have economic effect and such economic effect must be substantial. For an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that, in the event there is an economic benefit or burden that corresponds to the allocation, the partner to whom the allocation is made must receive the economic benefit or bear such economic burden. See §1.704–1(b)(2)(ii).

Allocations to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides for: (i) the proper maintenance of the partners' capital accounts, (ii) upon liquidation of the partnership (or any partner's interest in the partnership) liquidating distributions are required to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all necessary adjustments for the partnership's taxable year during which the liquidation occurs, by the end of such taxable year, or if later, 90 days after the date of such liquidation, and (iii) if such partner has a deficit balance in the partner's capital account following the liquidation of the interest after taking into account all necessary adjustments for the partnership taxable year during which the liquidation occurs, the partner is unconditionally obligated to restore the deficit balance by the end of such taxable year (or, if later, within 90 days after the date of the liquidation), which amount is paid to the partnership's creditors or distributed to the other partners in accordance with their positive capital account balances. See §1.704–1(b)(2)(ii)(*b*).

Even if the partnership agreement does not require an unlimited deficit restoration obligation of a partner, the allocation may still have economic effect to the extent such allocation does not cause or increase a deficit balance in the partner's capital account (in excess of any limited dollar amount of such partner's deficit restoration obligation) if requirements (1) and (2) of §1.704–1(b)(2)(ii)(*b*) are satisfied and the partnership agreement contains a "qualified income offset." Section 1.704–1(b)(2)(ii)(*d*). Finally, allocations that do not otherwise have economic effect under the foregoing rules shall be deemed to have economic effect if at the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners if such rules had been satisfied regardless of the economic performance of the partnership. Section 1.704–1(b)(2)(ii)(*i*).

As a general rule, the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. See §1.704–1(b)(2)(iii). Even if the allocation affects substantially the dollar amounts to be received by the partners from the partnership, the economic effect of the allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. See §1.704–1(b)(2)(iii). This test is commonly referred to as the after-tax test. In determining the after-tax economic benefit or detriment of an allocation to a partner, the tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account. Finally, the economic effect of an allocation is not substantial in two situations described in §1.704–1(b)(2)(iii)(*b*) and (b)(2)(iii)(*c*). The latter two situations are generally described as "shifting" and "transitory" allocations, respectively.

If the partnership agreement provides for an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that does not have substantial economic effect, then the partner's distributive share of the income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership. References in section 704(b) or §1.704–1 to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated, taking into account all facts and circumstances relating to the economic arrangement of the partners. See §1.704–1(b)(3).

Section 1.704–1(b)(1)(iii) provides that an allocation that is respected under section 704(b) nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and §1.751–1(b)(2)(ii).

The proposed regulations clarify several aspects of the regulations under section 704. The proposed regulations generally provide a "look-through rule" for purposes of testing the substantiality of an allocation. The proposed regulations provide that in determining the after-tax economic benefit or detriment of a partnership allocation to any partner that is a look-through entity, the look-through rule takes into account the tax consequences that result from the interaction of the allocation with the tax attributes of any owner of the look-through entity. Similarly, in determining the after-tax economic benefit or detriment to any partner that is a member of a consolidated group, the proposed regulations generally provide that the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. The proposed regulations provide that a look-through entity means a partnership, subchapter S corporation, trust, an entity disregarded for Federal tax purposes, or certain controlled foreign corporations (CFCs).

The proposed regulations clarify that, for purposes of §1.704–1(b)(2)(iii)(*a*), the after-tax economic consequences of an allocation contained in the partnership agreement was compared to the after-tax economic consequences of the allocation made in accordance with the partners' interest in the partnership (within the meaning of §1.704–1(b)(3)). For that purpose, the partners' interest in the partnership was determined as if the allocations tested were not contained in the partnership agreement. Also, the proposed regulations remove the *per capita* presumption in §1.704–1(b)(3)(i). Finally, the proposed regulations include an example illustrating one circumstance where a provision other than section 704(b) may be used to reallocate partnership items.

Summary of Comments and Explanation of Provisions

The final regulations adopt the proposed regulations with clarification of certain aspects in response to the comments received.

A. *Look-Through Entities and Members of a Consolidated Group*

For purpose of applying the after-tax, shifting, and transitory tests to a partner that is a look-through entity, the final regulations provide that the tax consequences that result from the interaction of an allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such partner must be taken into account.

The final regulations define a look-through entity as a partnership, subchapter S corporation, trust, estate, an entity disregarded for Federal tax purposes, or certain controlled foreign corporations (CFCs). The final regulations change the look-through rule for CFCs (CFC look-through rule) to provide an ownership threshold that must be met in order to trigger look-through treatment. One comment suggested that, for administrative reasons, the look-through rule should apply only in cases involving partnerships (whether U.S. or foreign) that meet the control test in section 6038. The IRS and the Treasury Department agree that administrative concerns justify limiting the CFC look-through rule but are concerned that limiting the application of the rule as suggested would provide opportunities for abuse. Accordingly, the final regulations limit application of the CFC look-through rule to cases in which United Stated shareholders (within the meaning of section 951(b)) of the CFC in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits interests of the partnership.

In addition, the final regulations clarify that a CFC is treated as a look-through entity, but only with respect to allocations of items of income, gain, loss, or deduction that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. The Treasury Department and the IRS are further considering whether a CFC partner should be treated as a look-through entity in all cases and how any impact on the tax liability of a direct or indirect owner of the CFC partner resulting from actual or anticipated distributions of property by the CFC partner under section 301 should be taken into account in testing the substantiality of an allocation.

Comments were also received on other aspects of the look-through rule. One comment suggested that the definition of look-through entity be expanded to include estates. Because estates generally pass through attributes in the same manner as trusts, this comment is adopted. Another comment questioned the inclusion of disregarded entities in the list of look-through entities. The proposed regulations included disregarded entities because such entities are the actual state law partners in the partnership. The final regulations include disregarded entities in the list of look-through entities for this reason only.

Several comments requested modifications to the look-through rule based upon their contention that the rule was burdensome. One comment suggested the abandonment of the look-through rule entirely, believing the application of §1.701–2 would protect the concerns underlying the proposed regulations and would be less burdensome. Another comment suggested that a five year presumption be included with respect to the after-tax test in §1.704–1(b)(2)(iii)(*a*), such that the economic effect of any allocation occurring five years after the date upon which the allocation became a part of the partnership agreement would be presumed to be substantial. Finally, several comments requested either that the look-through rule apply only to partners owning more than 20 percent of the profits or capital of the partnership or that the look-through rule provide procedures to help partnerships ease the burden of considering the tax attributes of their partners and indirect owners.

One proposal to simplify the application of the look-through rule was to include a presumption that the partnership did not know and would not be required to investigate the tax attributes of any partner unless that partner directly or indirectly owns more than a 25 percent interest in the partnership's capital or profits. Alternatively, it was suggested that the final regulations provide certification procedures pursuant to which a partnership would be entitled to rely on a statement from its direct or indirect owner regarding such person's tax attributes.

The substantiality test in its present form was adopted in 1986. The Treasury Department and the IRS believe that the final regulations merely confirm the proper application of the substantiality test in those instances in which the partnership is owned by one or more look-through entities. In that respect, the look-through rule in the final regulations is not a change to the substantiality test. The Treasury Department and the IRS do not believe that it is necessary at this time to simplify the application of the substantiality test as suggested by the comments. However, to address the concerns expressed regarding the burden of the substantiality test as it applies to partnerships with look-through entity partners, the final regulations include a *de minimis* rule that provides that, for purposes of determining substantiality, the tax attributes of *de minimis* partners need not be taken into account. A *de minimis* partner is any partner, including a look-through entity, that owns less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item. Because of the inclusion of this *de minimis* rule, the final regulations do not provide for a certification procedure.

Some comments requested that the final regulations clarify what constitutes a "tax attribute" and an "interaction." The IRS and the Treasury Department believe that this issue is sufficiently addressed under the current regulations, and, therefore, no further guidance is provided in the final regulations.

Finally, one comment requested that the final regulations provide guidance for situations in which the interaction of an allocation to a look-through entity, such as a trust or estate, and the tax attributes of the beneficiary of the entity are dependent on other factors such as the timing and amount of distributions from the trust or estate to the beneficiary. For example, it may be difficult to evaluate an allocation to a partner that is a trust where it is not known what distributions the trust will make. The IRS and the Treasury Department believe that this issue is addressed by the "strong likelihood" language of the substantiality test and, therefore, the final regulations do not provide additional guidance.

B. *The Baseline for Comparison in §1.704–1(b)(2)(iii)*

Section 1.704–1(b)(2)(iii)(*a*) provides that the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement. Because taxpayers have suggested that the baseline comparison required by this provision is unclear, the proposed regulations clarified this rule, consistent with the provisions of §1.704–1(b)(1)(i), by explaining that the after-tax economic consequences that result from the allocation must be compared to such consequences that would result if the allocations were not contained in the partnership agreement and were determined in accordance with the partners' interests in the partnership.

One comment suggested that an inconsistency existed between identifying the partners' interests in the partnership as the baseline for comparison in §1.704–1(b)(2)(iii)(*a*)(*1*) and (2) and the conclusions reached by §1.704–1(b)(5) *Example 5*. According to this comment, paragraph (ii) of §1.704–1(b)(5) *Example 5* provides that the sharing percentages under the partners' interests in the partnership standard was 36 percent for one partner and 64 percent for the other partner. Comparing the after-tax economic consequences of the allocations contained in the partnership agreement with the 36/64 sharing percentages results in the after-tax economic consequences of one partner being enhanced and those of the other partner being substantially diminished. Thus, according to the comment, the conclusion in paragraph (i) of §1.704–1(b)(5) *Example 5* cannot be correct. The after-tax test, however, is applied by comparing the allocations contained in the partnership agreement with the consequences determined in accordance with the partners' interests in the partnership had the allocations not been part of the partnership agreement. In *Example 5*, aside from the allocations being tested, the partners shared all other items equally and made equal capital contributions. To apply the substantiality test to the special allocations in that example, the results were compared to what would have occurred if the partners had 50/50 sharing percentages. This comparison revealed that one partner's after-tax economic return was enhanced and no partner's after-tax return was substantially diminished. Thus, the specially allocated items had to be reallocated under the partners' interests in the partnership. Under the facts of *Example* 5, the partners' interests in the partnership were the 36/64 sharing percentages, which were the same percentages in which they actually shared the partnership's total income for the year. The reallocation did not change the percentages in which the partners shared total income, but rather, required that each item of income (that is, tax-exempt income and taxable interest and dividends included in total income) be shared in those same percentages. Thus, in *Example 5* the partners' interests in the partnership for purposes of reallocating the items that lacked substantial economic effect was determined to be different than the partners' interests in the partnership used to test substantiality.

One comment suggested that the comparison to the partners' interests in the partnership is equally applicable when testing shifting and transitory allocations under §1.704–1(b)(2)(iii)(*b*) and (*c*) as it is to the after-tax test under §1.704–1(b)(2)(iii)(*a*), and suggested that the final regulations so provide. This comment is adopted and, in order to further clarify that the partners' interests in the partnership (determined without regard to the allocation or allocations being tested) is the baseline for comparison when testing the substantiality of an allocation, whether under the after-tax test or the shifting or transitory allocation test, the final regulations remove the parenthetical clauses inserted by the proposed regulations and add a sentence to the end of §1.704–1(b)(2)(iii)(*a*)(*1*) that provides that references in §1.704–1(b)(2)(iii) to an allocation (or allocations) not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners' interests in the partnership (within the meaning of paragraph §1.704–1(b)(3)), disregarding the allocation (or allocations) being tested under §1.704–1(b)(2)(iii).

C. *Removal of Per Capita Presumption in §1.704–1(b)(3)*

The proposed regulations removed the *per capita* presumption in §1.704–1(b)(3). Because this section generally does not contain mechanical rules to determine the partners' interests in the partnership, one comment suggested that the presumption was necessary to reduce complexity, and therefore recommended that the final regulations reinsert the presumption. However, because the *per capita* presumption failed to consider factors relevant to a determination of the manner in which the partners agreed to share the economic benefits or burdens corresponding to the allocation of partnership items, the correct result was reached in very few cases. Accordingly, the Treasury Department and IRS believe that any benefits of the presumption are outweighed by the potential for incorrect determinations.

D. *Example 29*

In *Example 29* of the proposed regulations, B, a domestic corporation, and C, a controlled foreign corporation, form BC, a partnership organized under the laws of a foreign jurisdiction, with equal capital contributions. B and C are both wholly owned by A, a domestic corporation. Substantially all of BC's income would not be subpart F income if earned directly by C. For the first fifteen years of the partnership, gross income is allocated 10 percent to B and 90 percent to C, and all deductions and losses will be allocated 90 percent to B and 10 percent to C. After the initial fifteen year period, BC's gross income will be allocated 90 percent to B and 10 percent to C, and all deductions and losses will be allocated 10 percent to B and 90 percent to C. The example concludes that, apart from the application of section 704(b), the Commissioner may reallocate or otherwise not respect the allocations under other Code sections.

One comment questioned why *Example 29* did not contain a substantial economic effect analysis. Another comment inferred from the absence of a citation to §1.701–2 in *Example 29* that the partnership anti-abuse rule did not apply and would not be asserted by the IRS. *Example 29* was included in the proposed regulations only to reiterate the provisions contained in §1.704–1(b)(1)(iii) regarding the effect other sections may have on partnership allocations. Accordingly, the Treasury Department and IRS do not believe that any further analysis is necessary. Moreover the list of other sections that can affect the validity of a partnership allocation in §1.704–1(b)(1)(iii) is not an exhaustive list and, accordingly, the absence of a citation to §1.701–2 or other potentially applicable sections does not preclude the applicability of those provisions of law in the appropriate circumstances. The Treasury Department and IRS continue to consider issuing additional guidance addressing the proper treatment of special allocations of items of a partnership that is owned primarily by related parties. *Examples 29* and *30* in the proposed regulations have been renumbered as *Examples 28* and *29*, respectively, in these final regulations.

Effective/Applicability Date

The amendments made by these final regulations apply to partnership taxable years beginning on or after May 19, 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 also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of this regulation are Jonathan E. Cornwell and Kevin I. Babitz, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and Treasury Department participated in its development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Par. 2. Section 1.704–1 is amended as follows:

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

2. A sentence is added at the end of the paragraph (b)(2)(iii)(*a*).

3. Paragraphs (b)(2)(iii)(*d*) and (*e*) are added.

4. The last two sentences of paragraph (b)(3)(i) are removed.

5. Paragraph (b)(5) *Examples 28*, *29* and *30* are added.

The additions and revisions read as follows:

§1.704–1 Partner's distributive share.

* * * * *

(b) * * *

(1) * * *

(ii) *Effective/applicability dates*. (*a*) * * * Paragraphs (b)(2)(iii)(*a*) (last sentence), (b)(2)(iii)(*d*), (b)(2)(iii)(*e*), and (b)(5) *Example 28*, *Example 29*, and *Example 30* of this section apply to partnership taxable years beginning on or after May 19, 2008.

(2) * * *

(iii) * * * (*a*) * * * References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners' interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii).

* * * * *

(*d*) *Partners that are look-through entities or members of a consolidated group*—(*1*) *In general*. For purposes of applying paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section to a partner that is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner, whether directly or indirectly through one or more look-through entities, must be taken into account. For purposes of applying paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section to a partner that is a member of a consolidated group (within the meaning of §1.1502–1(h)), the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. See paragraph (b)(5) *Example 29* of this section.

(*2*) *Look-through entity.* For purposes of this paragraph (b)(2)(iii)(*d*), a *look-through entity* means—

(*i*) A partnership;

(*ii*) A subchapter S corporation;

(*iii*) A trust or an estate;

(*iv*) An entity that is disregarded for Federal tax purposes, such as a qualified subchapter S subsidiary under section 1361(b)(3), an entity that is disregarded as an entity separate from its owner under §§301.7701–1 through 301.7701–3 of this chapter, or a qualified REIT subsidiary within the meaning of section 856(i)(2); or

(*v*) A controlled foreign corporation if United States shareholders of the controlled foreign corporation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership's taxable year. In such case, the controlled foreign corporation shall be treated as a look-through entity, but only with respect to allocations of income, gain, loss, or deduction (or items thereof) that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. See paragraph (b)(2)(iii)(*d*)(*6*) for the definition of indirect ownership.

(*3*) *Controlled foreign corporations*. For purposes of this section, the term *controlled foreign corporation* means a controlled foreign corporation as defined in section 957(a) or section 953(c). In the case of a controlled foreign corporation that is a look-through entity, the tax attributes to be taken into account are those of any person that is a United States shareholder (as defined in paragraph (b)(2)(iii)(*d*)(5) of this section) of the controlled foreign corporation, or, if the United States shareholder is a look-through entity, a United States person that owns an interest in such shareholder directly or indirectly through one or more look-through entities.

(*4*) *United States person*. For purposes of this section, a *United States person* is a person described in section 7701(a)(30).

(*5*) *United States shareholder*. For purposes of this section, a *United States shareholder* is a person described in section 951(b) or section 953(c).

(*6*) *Indirect ownership*. For purposes of this section, indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 318, substituting the phrase "10 percent" for the phrase "50 percent" each time it appears.

(*e*) *De minimis* rule. For purposes of applying this paragraph (b)(2)(iii), the tax attributes of *de minimis* partners need not be taken into account. For purposes of this paragraph (b)(2)(iii)(e), a *de minimis* partner is any partner, including a look-through entity that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit. See paragraph (b)(2)(iii)(*d*)(*6*) of this section for the definition of indirect ownership.

* * * * *

(5) * * *

Example 28. (i) B, a domestic corporation, and C, a controlled foreign corporation, form BC, a partnership organized under the laws of country X. B and C each contribute 50 percent of the capital of BC. B and C are wholly-owned subsidiaries of A, a domestic corporation. Substantially all of BC's income would not be subpart F income if earned directly by C. The BC partnership agreement provides that, for the first fifteen years, BC's gross income will be allocated 10 percent to B and 90 percent to C, and BC's deductions and losses will be allocated 90 percent to B and 10 percent to C. The partnership agreement also provides that, after the initial fifteen year period, BC's gross income will be allocated 90 percent to B and 10 percent to C, and BC's deductions and losses will be allocated 10 percent to B and 90 percent to C.

(ii) Apart from the application of section 704(b), the Commissioner may reallocate or otherwise not respect the allocations under other sections. See paragraph (b)(1)(iii) of this section. For example, BC's allocations of gross income, deductions, and losses may be evaluated and reallocated (or not respected), as appropriate, if it is determined that the allocations result in the evasion of tax or do not clearly reflect income under section 482.

Example 29. PRS is a partnership with three equal partners, A, B, and C. A is a corporation that is a member of a consolidated group within the meaning of §1.1502–1(h). B is a subchapter S corporation that is wholly owned by D, an individual. C is a partnership with two partners, E, an individual, and F, a corporation that is a member of a consolidated group within the meaning of §1.1502–1(h). For purposes of paragraph (b)(2)(iii) of this section, in determining the after-tax economic benefit or detriment of an allocation to A, the tax consequences that result from the interaction of the allocation to A with the tax attributes of the consolidated group of which A is a member must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to B, the tax consequences that result from the interaction of the allocation with the tax attributes of D must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to C, the tax consequences that result from the interaction of the allocation with the tax attributes of E and the consolidated group of which F is a member must be taken into account.

Example 30. (i) A, a controlled foreign corporation, and B, a foreign corporation that is not a controlled foreign corporation, form AB, a partnership organized under the laws of country X. The partnership agreement contains the provisions necessary to comply with the economic effect safe harbor of paragraph (b)(2)(ii)(*b*) of this section. A is wholly-owned by C, a domestic corporation that is not a member of a consolidated group within the meaning of §1.1502–1(h). B is wholly owned by an individual who is a citizen and resident of country X and is not related to A. Neither A, B, nor AB, is engaged in a trade or business in the United States. A and B each contribute 50 percent of the capital of AB. There is a strong likelihood that in each of the next several years AB will realize equal amounts of gross income that would constitute subpart F income if allocated to A, and gross income that would not constitute subpart F income if allocated to A ("non-subpart F income"). A and B agree to share bottom-line net income from AB equally; however, rather than share all items of gross income equally, A and B agree that B will be allocated all of AB's subpart F income to the extent of its 50 percent share of bottom-line net income. In year 1, AB earns $60x of income, $30x of which is subpart F income and is allocated to B, and $30x of which is non-subpart F income and is allocated to A.

(ii) Although neither A nor B is subject to U.S. tax with respect to its distributive share of the income of AB, under paragraph (b)(2)(iii)(*d*) of this section, the tax attributes of C must be taken into account with respect to A for purposes of applying the tests described in paragraphs (b)(2)(iii)(*a*), (*b*), and (*c*) of this section. The allocations in year 1 have economic effect. However, the economic effect of the allocations is not substantial under the test described in paragraph (b)(2)(iii)(*b*) of this section because there was a strong likelihood, at the time the allocations became part of the AB partnership agreement, that the net increases and decreases to A's and B's capital accounts in year 1 would not differ substantially when compared to the net increases and decreases to A's and B's capital accounts for year 1 if the allocations were not contained in the partnership agreement, and the total tax liability from the income earned by AB in year 1 (taking into account the tax attributes of the allocations to C) would be reduced as a result of such allocations. Under paragraph (b)(3) of this section, the subpart F income and non-subpart F income earned by AB in year 1 must each be reallocated 50 percent to A and 50 percent to B.

* * * * *

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

Approved May 8, 2008.

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

(Filed by the Office of the Federal Register on May 16, 2008, 8:45 a.m., and published in the issue of the Federal Register for May 19, 2008, 73 F.R. 28699)

Section 3402.—Income Tax Collected at Source

26 CFR 31.3402(g)–1: Supplemental wage payments.
(Also: § 31.3401(b)–1(a).)

Supplemental wages; income tax. This ruling provides guidance with respect to income tax withholding in nine different situations involving the payment of supplemental wages. Rev. Ruls. 66–294 and 67–131 obsoleted.

Rev. Rul. 2008–29

ISSUE

How does an employer determine the amount of income tax required to be withheld under section 3402 of the Internal Revenue Code with respect to certain supplemental wages the employer pays to an employee.

FACTS

In this revenue ruling nine different situations are described: (1) commissions paid at fixed intervals with no regular wages paid to the employee; (2) commissions paid at fixed intervals in addition to regular wages paid at different intervals; (3) draws paid in connection with commissions; (4) commissions paid to the employee only when the accumulated commission credit of the employee reaches a specific numerical threshold; (5) a signing bonus paid prior to the commencement of employment; (6) severance pay paid after the termination of employment; (7) lump sum payments of accumulated annual leave; (8) annual payments of vacation and sick leave; and (9) sick pay paid at a different rate than regular pay. In these situations, it is assumed, for income tax and income tax withholding purposes, that there is no constructive receipt or constructive payment of wages before the actual payment of wages, that no amounts are required to be included in income under section 409A before the actual payment of wages, and that all payments are made on or after January 1, 2007. Except for Employee *F* in Situation 5, none of the employees below is paid more than $1,000,000 of supplemental wages during any calendar year.

Situation 1. Employee *A* works as a salesperson for employer *X*. During *A*'s career as an employee with *X*, *X* has paid *A* only commissions as compensation for services. *X* pays the commissions credited to *A* on a monthly basis.

Situation 2. Employee *B* works as a salesperson for employer *Y*. *Y* pays *B* a monthly salary of $10,000, which it pays on the first business day of the month. In addition to the salary, *Y* pays *B* a commission equal to 5 percent of sales. *Y* pays the amount of accumulated commissions to *B* each Monday unless the Monday is a federal holiday, in which case the amount is paid on the next business day. *Y* withholds income tax from the monthly salary paid to *B*.

Situation 3. Employee *C* works as a salesperson for employer *Z*. Under *C*'s employment arrangement, *Z* pays a $5,000 draw to *C* on a semimonthly basis. Together with the second $5,000 draw payment for a month, *Z* pays *C* the amount of commissions credited to him less the total amount of draws ($10,000) that *Z* pays *C* during that month. If *C*'s draws exceed the amount of commissions earned by *C* during that month, *Z* reduces the amount of the draws paid to *C* during the next month. If *C* terminates employment with *Z*, he is obligated to repay any draws received in excess of commissions earned. *C* receives no wage payments other than the semimonthly draw payments and the monthly commission payments.

Situation 4. Employee *D* has worked as a salesperson for employer *M* for a number of years, and has been compensated solely by commission. *M* pays *D* the commissions credited to *D* whenever her accumulated net commissions equal $1,000 or more. On January 13, *D* has $1,350 in accumulated commissions. This is the first day of the year the amount of commissions credited to her has equaled or exceeded $1,000, and *M* pays the full accumulated amount ($1,350) to *D* on January 14. This payment is the first payment of wages to *D* for the calendar year. *D* has $2,125 in accumulated commissions credited to her account on January 31, which is the next day in the calendar year that the amount of commissions credited to her has exceeded $1,000. *M* pays the full amount of accumulated commissions ($2,125) on February 1. This payment is the second payment of wages to *D* for the calendar year.

Situation 5. Under an employment contract entered into on May 1 of Year 1, Employee *F* is scheduled to begin performing services for employer *P* on October 1 of Year 1. *F* will receive regular wages of $75,000 per month for his services as an employee of *P*, and will have a monthly payroll period. On June 1 of Year 1, *P* pays *F* $2,100,000 as a bonus for signing the employment contract. *F* has received no wage payments in any year from *P* prior to the payment on June 1 of Year 1. *F* has received no wage payments from agents of *P* or any other person treated as the same employer as *P* under § 31.3402(g)–1(a)(3)(i) of the Employment Tax Regulations.

Situation 6. Employee *G* performs services for employer *S*, which has a severance pay plan for its employees. The plan provides that, generally, if an employee is involuntarily terminated, the employee will receive weekly severance pay equal to his or her ending regular weekly pay. The severance pay will continue after termination for the number of weeks that is equal to the number of full years the employee performed services as an employee for the employer multiplied by 3. *G* is involuntarily terminated by *S* on June 30 of Year 1, after *G* has performed services as an employee of *S* for 17 years. Thus, *G* will receive 51 weeks of severance pay, which will be paid weekly starting in July of Year 1 and continuing into Year 2.

Situation 7. In general, Civil Service employees of the Federal Government earn specified hours of annual leave each 80-hour biweekly pay period, depending on the length of the employee's service. Employees, under usual circumstances, are permitted to accumulate earned but unused annual leave from year to year, up to a specified maximum number of hours.

When an employee leaves the service of the Federal Government, the employee receives his or her final payment of regular wages and, either in the same check or in a separate check, receives payment for any unused accumulated annual leave, computed at the employee's former regular pay rate. The terminating employee receives a report from the agency for which the employee works, or the agency's designated agent, specifying the amount of the payment of the accumulated annual leave. Federal agency *T* pays Employee *H* a lump sum payment for unused accumulated annual leave upon *H*'s termination of employment.

Situation 8. Employer *U* maintains a plan that pays its employees at the end of approximately each 12-month period a lump sum payment known as a vacation and sick leave allowance. An employee receives this payment whether or not he or she has been absent from work because of vacation or illness. However, in the event of absenteeism because of vacation or illness, the employee receives no regular pay for the period of absence. *U* makes a lump sum payment under the plan to employee *J*.

Situation 9. Employer *V* pays its employees at one rate when the employee is present and working and at another rate when the employee is absent because of sickness. The employer maintains payroll records that separately state the amount of wages paid for working days and the amount of wages paid for sick pay. *V* makes a single payment of wages to employee *K* for a payroll period, and the payment includes an amount for working days and an amount for sick pay.

LAW AND ANALYSIS

Section 31.3402(g)–1(a) of the regulations, as amended by T.D. 9276, 2006–2 C.B. 423, provides rules for determining whether wages paid to an employee are regular wages or supplemental wages. The amendments to the regulations are effective with respect to wages paid on or after January 1, 2007. Whether wages are classified as regular wages or supplemental wages may have significance in determining the amount of income tax required to be withheld.

Section 31.3402(g)–1(a)(1)(i) of the regulations provides that supplemental wages are all wages paid by an employer that are not regular wages. Supplemental wages include wage payments made without regard to an employee's payroll period, but also may include payments made for a payroll period. The regulations provide many examples of supplemental wages including commissions, bonuses, nonqualified deferred compensation includible in wages, and back pay. The regulations also provide that amounts that are described as supplemental wages in the definition in the regulations are supplemental wages regardless of whether the employer has paid the employee any regular wages during either the calendar year of the payment or any prior calendar year.

Section 31.3402(g)–1(a)(1)(ii) of the regulations provides that, as distinguished from supplemental wages, regular wages are amounts that are paid at a regular hourly, daily, or similar periodic rate (and not an overtime rate) for the current payroll period or at a predetermined fixed determinable amount for the current payroll period.

Section 31.3402(g)–1(a)(2) of the regulations provides that if a supplemental wage payment, when added to all supplemental wage payments previously made by one employer (as defined under the regulations) to an employee during the calendar year, exceeds $1,000,000, the rate used in determining the amount of withholding on the excess (including any excess which is a portion of a supplemental wage payment) shall be equal to the highest rate of tax applicable under section 1 of the Code for such taxable years beginning in such calendar year. This flat rate shall be applied without regard to whether income tax has been withheld from the employee's regular wages, without allowance for the number of withholding allowances claimed by the employee on Form W–4, "*Employee's Withholding Allowance Certificate*," without regard to whether the employee has claimed exempt status on Form W–4, without regard to whether the employee has requested additional withholding on Form W–4, and without regard to the withholding method used by the employer. Withholding under § 31.3402(g)–1(a)(2) is referred to as mandatory flat rate withholding.

If the supplemental wages paid to an employee by an employer (as defined in the regulations) during a calendar year do not exceed $1,000,000, then the amount of income tax withholding is determined under the rules provided in § 31.3402(g)–1(a)(6) and (7). These paragraphs describe two procedures for withholding on supplemental wages: the aggregate procedure and optional flat rate withholding.

An employer applies the aggregate procedure described in § 31.3402(g)–1(a)(6) by using the withholding tables applicable to the payroll period with respect to which the employer is calculating the income tax withholding liability on the supplemental wages. The supplemental wages, if paid concurrently with wages for a payroll period, are aggregated with the wages paid for such payroll period. If not paid concurrently, the supplemental wages are aggregated with the wages paid or to be paid within the same calendar year for the last preceding payroll period or for the current payroll period, if any. The amount of tax to be withheld is determined as if the aggregate of the supplemental wages and the regular wages constituted a single wage payment for the regular payroll period.

The aggregate procedure can be used to determine the amount of income tax to be withheld with respect to any payment of supplemental wages, except to the extent that mandatory flat rate withholding applies. See § 31.3402(g)–1(a)(6) of the regulations. However, optional flat rate withholding may only be used under certain conditions.

Under § 31.3402(g)–1(a)(7)(i) of the regulations, an employer must meet the following conditions at the time of payment to use optional flat rate withholding with respect to a supplemental wage payment or portion of a payment:

(A) The wage payment or portion of the payment is not subject to mandatory flat rate withholding under § 31.3402(g)–1(a)(2) of the regulations;

(B) The supplemental wages are either not paid concurrently with regular wages or are separately stated on the payroll records of the employer; and

(C) Income tax has been withheld from regular wages of the employee during the calendar year of the payment of the supplemental wages or the preceding calendar year.

In determining the amount of income tax withholding applicable under the aggregate procedure, it is necessary to determine the payroll period of the employee so that the correct withholding table can be applied. Withholding tables are updated each year and are found in Publication 15, *(Circular E), Employer's Tax Guide*.

Section 31.3401(b)–1(a) of the regulations provides that the term "payroll period" means the period of service for which a payment of wages is ordinarily made to an employee by his or her employer. It is immaterial that the wages are not always paid at regular intervals.

Section 31.3401(b)–1(b) of the regulations provides that for purposes of section 3402, an employee can have only one payroll period with respect to wages paid by any one employer. Thus, if an employee is paid a regular wage for a weekly payroll period and in addition thereto is paid supplemental wages (for example, bonuses) determined with respect to a different period, the payroll period is the weekly payroll period.

Section 31.3401(b)–1(d) of the regulations provides that the term "miscellaneous payroll period" means a payroll period other than a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual payroll period.

Employers may elect to use either the percentage method of withholding or the wage bracket method of withholding in withholding on regular wages of an employee. In applying the aggregate procedure applicable to supplemental wages, the employer will ordinarily apply the method of withholding used with respect to regular wages if the employer pays regular wages to the employee. Section 31.3402(b)–1 of the regulations provides that the amount of tax to be deducted and withheld under the percentage method of withholding shall be determined under the applicable percentage method of withholding table contained in Publication 15, according to the instructions contained therein. Similarly, § 31.3402(c)–1(a)(1) of the regulations provides that the correct amount of withholding under the wage bracket method shall be determined under the applicable wage bracket withholding table contained in Publication 15 issued for use with respect to the period in which such wages are paid.

Section 3402(c)(3) and § 31.3402(c)–1(c)(3) of the regulations provide, with respect to wage bracket withholding, that if wages are paid to an employee without regard to any particular period, as, for example, commissions paid to a salesperson upon consummation of a sale, the amount of tax to be deducted and withheld shall be determined in the same manner as in the case of a miscellaneous payroll period containing a number of days (including Saturdays, Sundays, and holidays) equal to the number of days (including Saturdays, Sundays, and holidays) which have elapsed *beginning with* the latest of the following days:

(i) The first day after the last payment of wages to such employee by such employer in the calendar year, or

(ii) The date on which such individual's employment with such employer began in the calendar year, or

(iii) January 1 of such calendar year, and *ending with* (and including) the date on which such wages are paid.

Situation 1. Section 31.3402(g)–1(a)(1)(i) of the regulations specifically includes commissions as an example of supplemental wages. Amounts included as supplemental wages under the definition in the regulations are supplemental wages regardless of whether the employer has paid the employee any regular wages during either the calendar year of the payment or any prior calendar year. Because the commission payments are supplemental wages, *X* has paid *A* only supplemental wages and no regular wages.

An employer determines income tax withholding on a payment of supplemental wages under either the aggregate procedure or optional flat rate withholding. *X* may not use the optional flat rate method with respect to the wages paid to *A* because one of the three requirements set forth in § 31.3402(g)–1(a)(7)(i) has not been met. *X* has not withheld income tax from regular wages paid to *A* during the calendar year or the preceding calendar year. Therefore, *X* must use the aggregate procedure to determine the amount of income tax withholding on the commissions paid to *A*.

The payroll period of any particular employee is the period of service for which a payment of wages is ordinarily made to an employee by the employer. See § 31.3401(b)–1(a). *A* receives no regular wages; therefore, the payroll period cannot be determined with respect to regular wage payments made by *X* but is determined by the period of service for which the payments of supplemental wages are ordinarily paid by *X* to *A*. Because *X* makes payments of the commissions to *A* on a monthly basis, *A* has a monthly payroll period. Therefore, *X* determines withholding on the commissions by using the applicable table for a monthly payroll period found in Publication 15.

Situation 2. *Y* is paying *B* both regular wages (the salary) and supplemental wages (the commissions). Because the regular wages are paid on a monthly basis, *B* has a monthly payroll period. The frequency of payment of the supplemental wages has no effect on the determination of *B*'s payroll period because *B* receives periodic regular wage payments during the calendar year.

Y may use either the aggregate procedure or optional flat rate withholding to determine income tax withholding on the commissions paid to *B*. Under the facts here, *Y* did not pay the supplemental wages concurrently with the wages for the payroll period. Therefore, if *Y* uses the aggregate procedure, *Y* may include, in the calculation of the aggregate of regular wages and supplemental wages, the regular wage payments for either the current or the last preceding payroll period. In calculating the aggregate wages, the employer would also include any other supplemental wage payments made for such payroll period. Thus, for example, in determining the correct withholding on the fourth commission payment during a month under the aggregate procedure, *Y* needs to aggregate regular wages paid for the payroll period plus the three prior commission payments for the payroll period (and any other supplemental wage payments paid for that payroll period) and then apply the applicable monthly payroll table in Publication 15. Because *Y* has withheld income tax from regular wages paid to *B*, *Y* may also use optional flat rate withholding to determine the amount of withholding on the supplemental wage payments to *B*.

Situation 3. Under this wage structure, the draws represent payments of commissions that are supplemental wages. The draws are debited against commissions, and the employer reduces the amount of the draws if they exceed commissions. Thus, the payment of the draw is a payment of commissions and not a payment of salary, and constitutes supplemental wages not regular wages. Therefore, *Z* is paying only supplemental wages to *C*, and, as in situation 1, the employer must use the aggregate procedure in determining the amount of withholding on the payments of wages to the employee. Because *Z* ordinarily pays *C* her supplemental wages on a semimonthly basis, *C* has a semimonthly payroll period. Thus, *Z* should use the applicable semimonthly withholding table in Publication 15 in determining withholding on payments to *C*.

Situation 4. Under the facts of this situation, *D* is receiving only supplemental wages, and thus *M* must use the aggregate procedure in determining income tax withholding required under section 3402. However, the wages are not paid at regular intervals. Because the wages are not paid based on a period of service, but on some other basis (*i.e.*, the date the amount of unpaid commissions credited to the employee equals or exceeds $1,000), the income tax withheld from the wages paid to *D* is based on the rules applicable to wages paid without regard to any period provided in § 31.3402(c)–1(c)(3) or Publication 15. Under these rules, the income tax to be withheld is determined based on the applicable table for a miscellaneous payroll period. The first payment to the employee is treated as a payment for a miscellaneous payroll period of 15 days, and the employer determines the income tax withholding based on that period. The 15 days is derived from a beginning date of January 1, which is the latest of (a) the first day after the last payment of wages to such employee by such employer in the calendar year, (b) the date on which the employee began employment with such employer in the calendar year, and (c) January 1 of the calendar year, and an ending date of January 15, the date on which the wages were paid. Similarly, the withholding on the second wage payment is determined based on a miscellaneous payroll period of 17 days, from January 16 (the day after the last payment of wages) to February 1, the date on which the wages were paid.

Situation 5. The bonus payment on June 1 of Year 1 is supplemental wages. See Rev. Rul. 2004–109, 2004–2 C.B. 958, and § 31.3402(g)–1(a)(1). To the extent the bonus exceeds $1,000,000, *P* is required to apply mandatory flat rate withholding under § 31.3402(g)–1(a)(2) because the supplemental wages paid to *F* by *P* exceed $1,000,000 for the calendar year. Thus, *P* is required to apply mandatory flat rate withholding with respect to $1,100,000 of the bonus.

With respect to the first $1,000,000 portion of the signing bonus, *P* has the choice of either applying the aggregate procedure or treating the amount as subject to mandatory flat rate withholding. See § 31.3402(g)–1(a)(4)(iv) of the regulations, which provides that, in the case of a supplemental wage payment that, when added to all supplemental wage payments previously made by the employer to the employee in the calendar year, results in the employee having received in excess of $1,000,000 supplemental wages for the calendar year, the employer may subject the entire amount of such supplemental wage payment to mandatory flat rate withholding. If *P* uses the aggregate procedure, the payroll period to be applied with respect to determining the amount of income tax to be withheld on the first $1,000,000 portion of the bonus is the monthly payroll period, because the regular wage payments to be paid to *F* during the calendar year are scheduled to be paid on a monthly basis. *P* may not use optional flat rate withholding to determine income tax withholding on *F*'s signing bonus because at the time the bonus is paid *P* has not withheld income tax from regular wages paid during year 1 or the preceding year.

Situation 6. Severance pay is supplemental wages because it is not a payment for services in the current payroll period but a payment made upon or after termination of employment for an employment relationship that has terminated. Thus, although the payments in this situation are for a fixed determinable amount for 51 weeks, they are not fixed payments for the current payroll period and thus are not regular wages.

Because the severance pay is supplemental wages, the usual rules for determining income tax withholding with respect to supplemental wages apply. *S* can use the aggregate procedure to determine withholding on the payments. Alternatively, if *S* has withheld income tax on regular wages paid to *G* in Year 1, *S* can use optional flat rate withholding to determine the withholding with respect to the supplemental wage payments in Year 1 and Year 2.

Situation 7. The lump sum payment of accumulated annual leave is a supplemental wage payment, because it is not a payment at a regular rate for the current payroll period. *T* can use the aggregate procedure in determining income tax withholding with respect to the amount of the accumulated annual leave payment. *T* separately states the amount of the supplemental wages on its payroll records. Thus, if *T* has withheld income tax from regular wages paid to *H* during the calendar year or the preceding calendar year, *T* can use optional flat rate withholding to determine the withholding with respect to the supplemental wage payment.

Situation 8. The annual payment of the vacation and sick leave allowance is a supplemental wage payment, because it is not a payment at a regular rate for the current payroll period. *U* can use the aggregate procedure to determine the income tax withholding with respect to the leave allowance payment. The supplemental wages are not paid concurrently with regular wages, and thus *U* meets one of the requirements for use of optional flat rate withholding, that the supplemental wage payment must be either not paid concurrently with regular wages or separately stated on the payroll records of the employer. If *U* has withheld income tax from regular wages paid to *J* during the calendar year or the preceding calendar year, *U* can use optional flat rate withholding to determine the withholding on the leave allowance payment.

Situation 9. The portion of the wage payment for sick days is supplemental wages, because the sick pay is paid at a different rate than the regular wages paid the employee. *V* can use the aggregate procedure to determine withholding with respect to the sick pay. *V* separately states the amount of the sick pay on its payroll records. Thus, if *V* has withheld income tax from regular wages paid to *K* during the calendar year or the preceding calendar year, *V* can use optional flat rate withholding to determine the withholding on the sick pay.

HOLDINGS

Situation 1. *X* must use the aggregate procedure described in § 31.3402(g)–1(a)(6) in determining the amount of income tax withholding on the payments of commissions to *A*. Because the supplemental wages are ordinarily paid for a monthly period of service, *X* should use the applicable withholding table for a monthly payroll period found in Publication 15 in applying the aggregate procedure.

Situation 2. *Y* is permitted to use either optional flat rate withholding or the aggregate procedure. If *Y* is applying the aggregate procedure, *Y* must aggregate all wages paid to *B* for the monthly payroll period, including all payments of supplemental wages for that payroll period.

Situation 3. The payments of the draws are supplemental wages. Therefore, *Z* is paying only supplemental wages to *C*, and, as in Situation 1, *Z* must use the aggregate procedure in determining the amount of withholding on the wages paid to *C*.

Situation 4. *M* is required to use the aggregate procedure in determining the amount of income tax to be withheld. Furthermore, because *D* is paid supplemental wages without regard to any particular period of service, income tax withholding on the payments of the supplemental wages is determined under the rules applicable for wages paid without regard to any period under § 31.3402(c)–1(c)(3), if the employer is using the wage bracket method, or under Publication 15, if the employer is using the percentage method of withholding.

Situation 5. The signing bonus is a supplemental wage payment. To the extent the signing bonus exceeds $1,000,000, *P* is required to apply mandatory flat rate withholding under § 31.3402(g)–1(a)(2) because *F* will have received in excess of $1,000,000 in supplemental wages from *P* during the calendar year. Thus, $1,100,000 of the signing bonus is subject to mandatory flat rate withholding. In determining the payroll period applicable with respect to the payment of the signing bonus, *P* uses the payroll period for which regular wages will be paid the employee. With respect to the first $1,000,000 of the bonus, *P* may either treat the amount as subject to mandatory flat rate withholding or withhold using the aggregate procedure based on a monthly payroll period.

Situation 6. The severance pay paid to *G* is supplemental wages. Therefore, *S* should withhold on the payments under the rules applicable in determining withholding on supplemental wages.

Situation 7. The lump sum annual leave payment is a supplemental wage payment. Therefore, *T* should withhold on the payment under the rules applicable in determining withholding on supplemental wages.

Situation 8. The lump sum annual payment for vacation and sick leave is a supplemental wage payment. Therefore, *U* should withhold on the payment under the rules applicable in determining withholding on supplemental wages.

Situation 9. The amount paid for sick pay is supplemental wages. Therefore, *V* should withhold on the payment under the rules applicable in determining withholding on supplemental wages.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 67–131, 1967–1 C.B. 291, and Rev. Rul. 66–294, 1966–2 C.B. 459, are obsolete. This revenue ruling and § 31.3402(g)–1(a) of the regulations, as amended by T.D. 9276, provide rules with respect to the types of payments described in Rev. Rul. 66–294 and Rev. Rul. 67–131.

DRAFTING INFORMATION

The principal author of this revenue ruling is Alfred G. Kelley of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Mr. Kelley at (202) 622–6040 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Treatment of Property Used to Acquire Parent Stock in Certain Triangular Reorganizations Involving Foreign Corporations

REG–136020–07

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9400) under section 367(b) of the Internal Revenue Code (Code) regarding certain triangular reorganizations. The regulations implement rules described in Notice 2006–85, 2006–2 C.B. 677, and Notice 2007–48, 2007–25 I.R.B. 1428. The regulations primarily affect corporations engaged in certain triangular reorganizations involving one or more foreign corporations. The text of those regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by August 25, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–136020–07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–136020–07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–136020–07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Daniel McCall, (202) 622–3860; concerning submissions of comments, requests for a public hearing, and/or to be placed on the building access list to attend a hearing, contact Richard Hurst (*Richard.A.Hurst@irscounsel.treas.gov*) or (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 367(b) of the Code and certain triangular reorganizations. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and the proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required.

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based on the fact that the regulations will primarily affect large multi-national corporations that engage in triangular reorganizations subject to the regulations. The regulations apply to triangular reorganizations, involving one or more foreign corporations, to the extent that, in connection with the reorganization, the acquiring corporation purchases, in exchange for property, all or a portion of the stock used to acquire the stock or assets of the target corporation. Therefore, the IRS and Treasury Department expect only a *de minimis* number of small business entities to be subject to the regulations. Pursuant to section 7805(f) of the Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

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

Drafting Information

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

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.367(a)–3(b)(2)(i)(C) also issued under 26 U.S.C. 367(a) and (b). * * *

Section 1.367(b)–14 also issued under 26 U.S.C. 367(b). * * *

Par. 2. Section 1.367(a)–3 is amended by adding new paragraph (b)(2)(i)(C) to read as follows:

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

* * * * *

(b) * * *

(2) * * *

(i) * * *

(C) [The text of this proposed amendment to §1.367(a)–3(b)(2)(i)(C) is the same as the text of §1.367(a)–3T(b)(2)(i)(C) published elsewhere in this issue of the Bulletin].

* * * * *

Par. 3. Section 1.367(b)–14 is added to read as follows:

§1.367(b)–14 Acquisition of parent stock for property in triangular reorganizations.

[The text of proposed §1.367(b)–14 is the same as the text of §1.367(b)–14T(a) through (e)(5) published elsewhere in this issue of the Bulletin.]

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

(Filed by the Office of the Federal Register on May 23, 2008, 8:45 a.m., and published in the issue of the Federal Register for May 27, 2008, 73 F.R. 30330)

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

Announcement 2008–54

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

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on June 16, 2008, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Community Child Care
Portland, OR

Camp Meeting of the Assoc. of the Newark Conf. of the Methodist Episcopal Church
Mount Tabor, NJ

Berryessa PAL Youth Football Club, Inc.
San Jose, CA

Rape Survivors Anonymous World Services, Inc.
Oswego, IL

Round Rock Band Boosters, Inc.
Round Rock, TX

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

Bulletins 2008–1 through 2008–24

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2007–27 through 2007–52 is in Internal Revenue Bulletin 2007–52, dated December 26, 2007.

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

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