Internal Revenue
bulletin

Bulletin No. 2007-35
August 27, 2007

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

T.D. 9338, page 463.

Final regulations under sections 6038 and 6038A of the Code clarify the information required to be furnished regarding certain related party transactions of certain foreign corporations and certain foreign-owned domestic corporations. The final regulations also increase the amount of certain penalties, and make certain other changes, to reflect the statutory changes made by the Taxpayer Relief Act of 1997.

T.D. 9339, page 437.
REG–121475–03, page 474.

Final, temporary, and proposed regulations under section 1397E of the Code set forth guidance for state and local governments that issue qualified zone academy bonds (QZABs) and for banks, insurance companies, and other taxpayers that hold those bonds. The regulations provide guidance on the maximum term, expenditure and use of proceeds, remedial actions, arbitrage, and reporting requirements for QZABs.

T.D. 9341, page 449.

Final regulations under section 1502 of the Code that provide guidance with regard to the recalculation of basis and excess loss accounts in subsidiary shares as the result of certain intercompany transactions and on when a subsidiary stock can be treated as worthless under section 165.

T.D. 9342, page 451.

Final regulations under section 1502 of the Code amend the consolidated return regulations relating to the tacking rule of the life-nonlife regulations and taxable years of members of a consolidated group. Specifically, the regulations remove one of the five conditions of the tacking rule (the separation condition) and regulations section 1.1502–76(a)(2), which requires a fiscal-year consolidated group with an insurance member to adopt a calendar year.

Notice 2007–60, page 466.

Section 355. This notice provides transition relief to taxpayers applying regulations section 1.355–3(b)(4)(iii) and sections 355(b)(2)(C) and (D) of the Code to certain transactions described in this notice.

Notice 2007–71, page 472.

Notice 2003–81, 2003–2 C.B. 1223, identified a tax avoidance transaction involving offsetting foreign currency options and those substantially similar to it as listed transactions. This notice modifies and supplements Notice 2003–81 by correcting a statement in its "Facts" section. Specifically, this notice clarifies that foreign currency options, whether or not the underlying currency is one in which positions are traded through regulated futures contracts, are not foreign currency contracts as defined in section 1256(g)(2). Notice 2003–81 modified and supplemented.

EMPLOYEE PLANS

Notice 2007–67, page 467.

Section 906 of Pension Protection Act of 2006; Indian tribal governments; extension of transition relief. This notice extends the transition relief for plans of Indian tribal governments and related entities to comply with the changes made by section 906 of the Pension Protection Act of 2006 (PPA '06) to the date that is six months after the issuance of additional guidance under section 414(d) of the Code as amended by section 906 of PPA '06. Notice 2006–89 modified.

(Continued on the next page)

Announcements of Disbarments and Suspensions begin on page 476.
Finding Lists begin on page ii.
Index for July through August begins on page iv.

Department of the Treasury
Internal Revenue Service

Notice 2007–68, page 468.

Weighted average interest rate update; corporate bond indices; 30-year Treasury securities. The weighted average interest rate for August 2007 and the resulting permissible range of interest rates used to calculate current liability and to determine the required contribution are set forth.

Notice 2007–69, page 468.

Normal retirement age; temporary relief. This notice provides temporary relief for certain pension plans whose definition of normal retirement age may be required to be changed to comply with the regulations regarding a plan's normal retirement age that were recently issued under section 401(a) of the Code. Rev. Proc. 2007–4 and Notice 2007–3 modified.

EMPLOYMENT TAX

T.D. 9337, page 455.

Final regulations under section 3402 of the Code provide guidance for employers and for employees who must submit to their employers a withholding exemption certificate. The regulations provide rules for withholding when the IRS notifies the employer and the employee of the marital status and maximum number of withholding exemptions permitted for calculating the employee's withholding. The regulations also provide rules for the use of substitute forms and preserve the IRS's ability to require the submission of certain copies of withholding exemption certificates.

ADMINISTRATIVE

T.D. 9336, page 461.

Final regulations under section 6012 of the Code revise the filing requirements for Subchapter T cooperatives, instructing all such cooperatives to file their returns on the newly developed Form 1120–C, *U.S. Income Tax Return for Cooperative Associations*. Announcements 84-26 and 84-37 obsoleted.

Announcement 2007–74, page 483.

This document contains corrections to proposed regulations (REG–157711–02, 2007–8 I.R.B. 537) which apply to corporations filing consolidated returns and implement aspects of the repeal of the General Utilities doctrine by redetermining members' bases in subsidiary stock and requiring certain reductions in subsidiary stock basis on a transfer of the stock.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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

Section 1256.—Section 1256 Contracts Marked to Market

A notice clarifies that foreign currency options, whether or not the underlying currency is one in which positions are traded through regulated futures contracts, are not foreign currency contracts as defined in section 1256(g)(2). See Notice 2007-71, page 472.

Section 1397E.—Credit to Holders of Qualified Zone Academy Bonds

26 CFR 1.1397E–1: Qualified zone academy bonds.

T.D. 9339

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Qualified Zone Academy Bonds; Obligations of States and Political Subdivisions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that provide guidance to state and local governments that issue qualified zone academy bonds and to banks, insurance companies, and other taxpayers that hold those bonds on the program requirements for qualified zone academy bonds. The temporary regulations implement the amendments to section 1397E of the Internal Revenue Code (Code) (discussed in this preamble) and provide guidance on the maximum term, permissible use of proceeds, and remedial actions for qualified zone academy bonds. The text of these temporary regulations also serves as the text of the proposed regulations (REG–121475–03) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin. The portions of this rule that are final regulations provide necessary cross-references to the temporary regulations.

DATES: *Effective Date:* These regulations are effective on September 14, 2007.

Applicability Date: For dates of applicability, see §1.1397E–1T(m) of these regulations.

FOR FURTHER INFORMATION CONTACT: Timothy L. Jones or Zoran Stojanovic, (202) 622–3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1908. Responses to this collection of information are required to obtain or retain a benefit.

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

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

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

Background

Section 1397E(a) of the Code provides that an eligible taxpayer (within the meaning of section 1397E(d)(6)) that holds a qualified zone academy bond ("QZAB" or "QZABs") on a credit allowance date is allowed a credit against Federal income tax for the taxable year that includes the credit allowance date. In general, a QZAB is a bond issued by a state or local government to finance certain eligible public school purposes under section 1397E(d). Section 1397E(b) provides that the amount of the QZAB credit equals the product of the credit rate and the face amount of the bond held by the taxpayer on the credit allowance date. Under section 1397E(b)(2), the credit rate is determined by the Treasury Department and equals the percentage that the Department estimates generally will permit the issuance of QZABs without discount and without interest cost to the issuer. Section 1397E(i)(1) defines "credit allowance date" as the last day of the one-year period beginning on the issue date of the issue and the last day of each successive one-year period thereafter. Under section 1397E(d)(3), the maximum term of a QZAB is determined by the Treasury Department and equals the term that the Treasury Department estimates will result in the present value of the obligation to repay the principal on the bond being equal to 50 percent of the face amount of the bond.

Section 1397E(j) provides that the amount of the QZAB credit allowed to the taxpayer is included in the taxpayer's gross income.

Section 1397E(e) imposes a national limitation on the amount of QZABs that may be issued for each calendar year. The limitation is allocated by the Treasury Department among the States on the basis of their respective populations of individuals below the poverty line.

Section 1397E was amended by section 107 of the Tax Relief and Health Care Act of 2006, Public Law 109–432, 120 Stat. 2922 (2006) (the "2006 Act"), by adding certain requirements for a bond to be a QZAB. In general, the 2006 Act added a new five-year spending period requirement, arbitrage investment restrictions, and information reporting requirements. Specifically, the 2006 Act added new section 1397E(f), which generally imposes

spending period restrictions under which an issuer of QZABs must reasonably expect, as of the issue date, that: (1) at least 95 percent of the proceeds from the sale of the issue are to be spent for one or more qualified purposes with respect to qualified zone academies within the 5-year period beginning on the issue date of the QZAB; (2) a binding commitment with a third party to spend at least 10 percent of the proceeds from the sale of the issue will be incurred within the six-month period beginning on the issue date of the QZAB; and (3) such purposes will be completed with due diligence and the proceeds from the sale of the issue will be spent with due diligence. New Section 1397E(f)(2) added by the 2006 Act provides authority to the Secretary of the Treasury to extend the five-year spending period. To the extent that less than 95 percent of the proceeds of the issue are spent within the five-year spending period (plus any extension granted by the Secretary of the Treasury), the 2006 Act requires the issuer to redeem the nonqualified bonds within 90 days after the end of such period.

In addition, the 2006 Act added new section 1397E(g), which generally requires that an issue of QZABs must satisfy the arbitrage investment restrictions of section 148 with respect to the proceeds of the issue.

Finally, the 2006 Act added new section 1397E(h), which generally requires that issuers of QZABs submit information reporting returns to the IRS similar to the information reporting returns required to be submitted to the IRS under section 149(e) for tax-exempt state or local bonds.

Temporary regulations (T.D. 8755, 1998–1 C.B. 653) interpreting section 1397E were published on January 7, 1998 (63 FR 671), and amended on July 1, 1999 (T.D. 8826, 1999–2 C.B. 107 [64 FR 35573]). Final regulations under section 1397E (T.D. 8903, 2000–2 C.B. 352) were published on September 26, 2000 (65 FR 57732) (the "Final Regulations"). On March 26, 2004, a notice of proposed rulemaking (REG–121475–03, 2004–1 C.B. 793) was published in the **Federal Register** (69 FR 15747) (the "2004 Proposed Regulations"). The 2004 Proposed Regulations proposed to amend the existing Final Regulations by providing guidance on the maximum term, permissible use of proceeds, and remedial actions for QZABs. A public hearing was scheduled for July 21, 2004. The public hearing was cancelled because no requests to speak were received. Written comments on the 2004 Proposed Regulations were received. After consideration of the written comments, and in light of the statutory changes made by the 2006 Act, the need for regulatory guidance on those statutory changes, and the close connection between that needed guidance and the guidance in the 2004 Proposed Regulations, the IRS and the Treasury Department have determined to issue coordinated guidance in these temporary regulations (the "Temporary Regulations"), with an opportunity for public comment in the corresponding proposed regulations (the "Proposed Regulations"). Set forth in this preamble is an explanation of certain provisions of the Temporary Regulations.

Explanation of Provisions

I. *Certain Definitions*

A. *In general*

The Temporary Regulations employ certain definitions used in the tax-exempt bond area. Thus, the Temporary Regulations employ certain definitions used for general tax-exempt bond purposes in §1.150–1 and certain definitions used for purposes of the arbitrage investment restrictions on tax-exempt bonds in §1.148–1(b).

B. *Definitions of various types of proceeds in general*

In general, §1.148–1(b) defines "sale proceeds" as any amounts actually or constructively received from the sale of an issue, including amounts used to pay underwriters' discount or compensation. In addition, §1.148–1(b) defines "investment proceeds" to mean any amounts actually or constructively received from investing proceeds of an issue. Further, §1.148–1(c) defines "replacement proceeds" to include certain amounts with a reasonable nexus to a bond issue, such as sinking funds reasonably expected to be used to pay debt service on a bond issue and pledged funds pledged to pay debt service on a bond issue with a reasonable assurance that the funds will be available to pay such debt service.

C. *Proceeds for purposes of the use and spending requirements*

In general, the Temporary Regulations provide that, for purposes of the QZAB provisions regarding the use and expenditure of proceeds for qualified purposes within prescribed periods, "proceeds" means sale proceeds, as defined in §1.148–1(b), plus investment proceeds, as defined in §1.148–1(b). Thus, under the Temporary Regulations, the requirement in section 1397E(d)(1)(A) to use at least 95 percent of the proceeds of an issue for a qualified purpose with respect to a qualified zone academy applies by taking into account both the sale proceeds of the issue and any investment proceeds received from investing those sale proceeds. Similarly, under the Temporary Regulations, the requirement in section 1397E(f) to spend at least 95 percent of the proceeds from the sale of an issue on qualified purposes within a five-year period and the associated requirements in section 1397E(f) apply to both sale proceeds of an issue and investment proceeds derived from investing sale proceeds.

Some commentators suggested that, for purposes of the 95-percent test, the definition of "proceeds" should be limited to sale proceeds and should exclude amounts received from investing sale proceeds. These commentators suggested that, when sizing a bond issue to comply with the 95-percent test, it could be difficult for an issuer to include investment earnings because interest rates may be volatile and the timing of expenditures may be uncertain. The IRS and the Treasury Department have considered this comment and have concluded that the definition of proceeds in the 2004 Proposed Regulations that applies for purposes of the 95-percent test is appropriate to ensure the use and expenditures of proceeds of QZABs for one or more qualified purposes under section 1397E(d)(5) and (f). Thus, the Temporary Regulations retain this provision. This approach is consistent with the view that, for purposes of certain similar provisions on qualified private activity bonds under section 141, which are based on use of 95% of the net proceeds, as defined in section 150(a)(3), for qualified purposes, net proceeds properly include both sale proceeds and investment proceeds pending expenditures for ultimate qualified

governmental purposes, with certain reductions inapplicable to QZABs.

D. *Proceeds for purposes of private business contribution*

Section 1397E(d)(1)(C)(ii) provides that a bond is a QZAB only if, among other requirements, the issuer certifies that it has written assurances that the private business contribution requirement of section 1397E(d)(2) will be met with respect to the qualified zone academy. Section 1397E(d)(2)(A) provides that the private business contribution requirement is met if the eligible local education agency that established the qualified zone academy has written commitments from private entities to make qualified contributions (as defined in section 1397E(d)(2)(B)) having a present value (as of the issue date of the issue) of not less than ten percent of the proceeds of the issue. The 2004 Proposed Regulations provide that, for purposes of the private business contribution requirement of section 1397E(d)(2), proceeds means sale proceeds, as defined in §1.148–1(b), without regard to any investment proceeds received or expected to be received from investing those sale proceeds. Commentators supported this narrower definition of "proceeds" in the 2004 Proposed Regulations for purposes of the private business contribution requirement. The Temporary Regulations retain this provision.

II. *Maximum Term*

Section 1397E(d)(3) provides that the Secretary of the Treasury Department shall determine, during each calendar month, the maximum term for QZABs issued during the following calendar month. Section 1397E(d)(3) states that the maximum term shall be the term that the Secretary estimates will result in the present value of the obligation to repay the principal on the bond being equal to 50 percent of the face amount of the bond. Section 1.1397E–1(d) of the existing Final Regulations provides that the maximum term for a QZAB is determined under section 1397E(d)(3) by using a discount rate equal to 110 percent of the long-term adjusted applicable Federal rate (AFR), compounded semi-annually, for the month in which the bond is issued. The IRS publishes the long-term adjusted AFR each month in a revenue ruling. See §601.601(d)(2)(ii)(*b*).

Section 1397E(b)(2) provides that the Secretary shall determine, during each calendar month, a credit rate for QZABs issued during the following calendar month. Section 1.1397E–1(b) provides that the Secretary shall determine monthly (or more often as deemed necessary by the Secretary) the credit rate the Secretary estimates generally will permit the issuance of a QZAB without discount and without interest cost to the issuer. Notice 99–35, 1999–2 C.B. 26, see §601.601(d)(2)(ii)(*b*) ("Notice 99–35"), indicates that, until further notice, the credit rate for a QZAB will be published daily by the Bureau of Public Debt on its Internet site for State and Local Government Series securities (*https://www.treasurydirect.gov*). Notice 99–35 also provides that the credit rate shall be applied to a QZAB on the first day on which there is a binding contract in writing for the sale or exchange of the bond. Notice 99–35 states that the credit rate will be determined by the Treasury Department based on its estimate of the yield on outstanding AA rated corporate bonds of a similar maturity for the business day immediately prior to the date on which there is a binding contract in writing for the sale or exchange of the bond.

Prior to the issuance of the 2004 Proposed Regulations, questions were raised regarding the maximum term of a QZAB that is sold in one month and issued in another month. Section 1.1397E–1(d) of the existing Final Regulations provides that the maximum term is determined based on the month in which the bond is issued. However, under Notice 99–35, the credit rate for a QZAB is determined based on the first day on which there is a binding contract in writing for the sale or exchange of the bond. The credit rate and maximum term should be determined on the same day because the credit rate for a bond depends on its maximum term. Accordingly, the 2004 Proposed Regulations would amend §1.1397E–1(d) to provide that the maximum term for a QZAB is determined based on the first day on which there is a binding contract in writing for the sale or exchange of the bond.

Commentators supported the maximum term provisions in the 2004 Proposed Regulations. The Temporary Regulations retain these provisions.

At the present time, the Treasury Department is continuing its current practice of publishing the credit rate and maximum term for QZABs on the Bureau of Public Debt's Internet site for State and Local Government Series securities (*https://www.treasurydirect.gov*).

III. *Use of Proceeds and Remedial Actions*

A. *In general*

Section 1397E(d)(1) provides that a bond issued as part of an issue is a QZAB only if, among other requirements, at least 95 percent of the proceeds of the issue are to be used for a qualified purpose with respect to a qualified zone academy established by an eligible local education agency (as defined in section 1397E(d)(4)(B)) and the issue meets the requirements of section 1397E(f) (relating to spending periods), section 1397E(g) (relating to arbitrage), and section 1397E(h) (relating to information reporting requirements). Section 1397E(d)(5) defines "qualified purposes" for any qualified zone academy to include: (i) rehabilitating or repairing the public school facility in which such academy is established, (ii) providing equipment for use at such academy, (iii) developing course materials for education to be provided at such academy, and (iv) training teachers and other school personnel in such academy. Section 1397E(d)(4)(A) defines "qualified zone academy" as any public school (or academic program within a public school) that is established by and operated under the supervision of an eligible local education agency to provide education or training below the postsecondary level if: (1) the public school or program is designed in cooperation with business in accordance with section 1397E(d)(4)(A)(i); (2) students in the public school or program will be subject to the same academic standards and assessments as other students educated by the eligible local education agency; (3) the comprehensive education plan of the public school or program is approved by the eligible local education agency; and (4) the public school is located in an empowerment zone or enterprise community (as defined in section 1393), or there is a reasonable expectation (as of the issue date of the bonds) that at least 35 percent of the students attending the school or par-

ticipating in the program will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act.

B. *Compliance with 95-percent test*

1. *In general*

The 2004 Proposed Regulations provide guidance on compliance with the 95-percent test in section 1397E(d)(1)(A). Specifically, the 2004 Proposed Regulations provide that, in general, an issue must satisfy two requirements to comply with section 1397E(d)(1)(A). First, the issuer must reasonably expect, as of the issue date of the issue, to use at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision). Second, except as otherwise provided in the remedial action provisions of the 2004 Proposed Regulations, at least 95 percent of the proceeds of the issue must actually be used for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision). For these purposes, under the 2004 Proposed Regulations, any unspent proceeds are treated as used for a qualified purpose with respect to a qualified zone academy during any period that the issuer reasonably expects that those proceeds will be spent with due diligence for a qualified purpose with respect to a qualified zone academy.

Some commentators suggested a modification of the requirement in the 2004 Proposed Regulations that at least 95 percent of the proceeds of an issue both be reasonably expected to be used and actually be used for a qualified purpose for the entire term of the issue. Specifically, these commentators requested that the requirement be altered to conform to the tax-exempt bond provisions of §1.141–2(d), which look to a similar standard based on reasonable expectations and deliberate actions within an issuer's control, with certain exceptions for involuntary conversions and actions in response to directives from the Federal government. These commentators noted that use of the standards under section 141 would be appropriate because the statutory language of sections 141 and 1397E both use the phrase "are to be used." In substance, the standards for interpreting this phrase under the 2004 Proposed Regulations and under section 141 both incorporate reasonable expectations and actual use, with certain special exceptions to actual use in the case of the standard under section 141. The IRS and the Treasury Department believe, however, that compliance standards for the actual use of proceeds appropriately may take into account the particular governmental program involved.

The Temporary Regulations do not adopt the suggestion to conform the 95-percent test for QZABs to the deliberate action provisions of §1.141–2(d). The Temporary Regulations retain the proposed standard based on reasonable expectations and actual use. The actual use test is set forth under section 1397E(f)(3), as introduced by the 2006 Act, and is appropriate for the circumstances involved with QZABs. In addition, the control-based exceptions to actual use under the deliberate action standard under section 141 raise certain administrability concerns in the context of QZABs. For example, it may be particularly difficult to determine if a loss of qualified zone academy status is within an issuer's control.

The Temporary Regulations provide guidance on the spending period requirements introduced by the 2006 Act in section 1397E(f). Specifically, the Temporary Regulations provide that an issuer must both reasonably expect to spend and actually spend at least 95 percent of the proceeds of an issue of QZABs within the five-year period beginning on the issue date of the issue of QZABs (or be subject to the additional requirement to redeem bonds from unspent proceeds at the end of that five-year period). The Temporary Regulations clarify that the various requirements relating to "reasonable expectations" for the use of proceeds of QZABs and actual actions to proceed with "due diligence" to spend such proceeds on qualified purposes are based on objective reasonableness standards, as used in the definition of "reasonable expectations or reasonableness" in §1.148–1(b) of the arbitrage regulations.

2. *Proceeds spent for rehabilitation, repair or equipment*

Section 1397E(d)(5)(A) and (B) provides that the term "qualified purpose" with respect to any qualified zone academy includes rehabilitating or repairing the public school facility in which such academy is established, and providing equipment for use at such academy. The 2004 Proposed Regulations specify that, if proceeds of an issue are spent for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure that (1) the property financed with those proceeds is used for the purposes of the academy and (2) the academy maintains its status as a qualified zone academy. For this purpose, the retirement from service of financed property due to normal wear or obsolescence does not cause the property not to be used for a qualified purpose with respect to a qualified zone academy.

The Temporary Regulations provide guidance on the applicable standard for determining whether proceeds of QZABs are used for a qualified purpose of "rehabiliting" a public school facility under section 1397E(d)(5)(A), based on a known existing standard used for purposes of the rehabilitation tax credit under section 47. In particular, in determining whether proceeds of QZABs are used for a qualified purpose of "rehabilitating" a public school facility under section 1397E(d)(5)(A), rules similar to those used for purposes of the rehabilitation tax credit in section 47(c) (other than sections 47(c)(1)(B)and 47(c)(2)(B)(v)) shall apply. Set forth in this preamble is a general description of certain aspects of this rehabilitation expenditure standard. In general, the rehabilitation standard under section 47 requires a substantial rehabilitation involving a building that already has been placed in service and a rehabilitation process that preserves specified portions of the existing walls of the building. Specifically, at least 50 percent of the existing external walls of the rehabilitated building must be retained as external walls, at least 75 percent of the existing external walls must be retained as internal or external walls, and at least 75 percent of the existing internal

structural framework must be retained. Under this rehabilitation standard, eligible rehabilitation expenditures include some expenditures for reconstruction, subject, however, to the foregoing restrictions on retention of certain percentages of the existing walls. In addition, however, under this rehabilitation standard, eligible rehabilitation expenditures do not include expenditures to enlarge existing buildings or expenditures to acquire existing buildings. In adopting the rehabilitation standard used in section 47 for purpose of section 1397E, the IRS and the Treasury Department declined to adopt one public comment which suggested that rehabilitation should include complete reconstruction of a building. Here, the IRS and the Treasury Department determined that such a broad interpretation of rehabilitation effectively to include new construction would be beyond Congressional intent.

3. *Proceeds spent to develop course materials or train teachers*

Section 1397E(d)(5)(C) and (D) provides that the term "qualified purpose" with respect to any qualified zone academy includes developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. The 2004 Proposed Regulations provide that, if proceeds of an issue are spent for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure. Commentators supported this provision of the 2004 Proposed Regulations. The Temporary Regulations retain this provision.

4. *Special rule for determining status as qualified zone academy*

Section 1397E(d)(4)(A)(iv) provides that a public school (or academic program within a public school) is a qualified zone academy only if, among other requirements, the public school is located in an empowerment zone or enterprise community, or there is a reasonable expectation (as of the issue date of the issue) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act.

For purposes of determining whether an issue complies with section 1397E(d)(4)(A)(iv), the 2004 Proposed Regulations provide that a public school is treated as located in an empowerment zone or enterprise community for the entire term of the issue if the public school is located in an empowerment zone or enterprise community on the issue date of the issue. Commentators agreed with this provision of the 2004 Proposed Regulations relating to empowerment zones and enterprise communities. The Temporary Regulations retain this provision.

Commentators also requested clarification of the relevant time period for determining compliance with the 35-percent free or reduced-cost school lunch program test. The Temporary Regulations provide that the test looks to whether there is a reasonable expectation (as of the issue date of the bonds) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches during the one-year period following the date the bonds are issued.

C. *Remedial actions*

1. *In general*

Prior to the issuance of the 2004 Proposed Regulations, comments were received requesting guidance specifying remedial actions that may be taken to cure a violation of the 95-percent test in section 1397E(d)(1)(A). The 2004 Proposed Regulations specify two remedial actions that may be taken in certain circumstances if less than 95 percent of the proceeds of an issue actually are used for a qualified purpose with respect to a qualified zone academy. These remedial actions are available only if the issuer reasonably expected on the issue date of the bonds that: (1) the issue would meet the requirements of section 1397E(f)(1)(A), (B), and (C); and (2) at least 95 percent of the proceeds of the issue would be used for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision).

As discussed in this preamble, the two remedial actions specified in the 2004 Proposed Regulations are (1) redemption or defeasance of the nonqualified bonds, and (2) alternative use of the disposition proceeds. If the applicable requirements are met, the redemption or defeasance remedial action is available to cure any failure to satisfy the 95-percent test that was not reasonably expected as of the issue date. The alternative use of disposition proceeds remedial action applies only to certain dispositions of financed property for cash.

Commentators recommended that the 2004 Proposed Regulations be amended to provide additional flexibility for issuers if the failure to properly use proceeds is based on a loss of status of the public school or academic program as a qualified zone academy. Consistent with the 2006 Act, the Treasury Department and the IRS have concluded that the remedial actions of redemption and defeasance in the 2004 Proposed Regulations will adequately address situations where there has been a disqualifying change in the status of an academy. The Temporary Regulations retain these two remedial actions with certain modifications relating to the amendments to section 1397E introduced by the 2006 Act.

2. *Redemption or defeasance of nonqualified bonds*

Under the 2004 Proposed Regulations, a redemption or defeasance remedial action is taken if: (1) all of the nonqualified bonds of the issue (determined by applying the principles of §1.142–2(e)) are redeemed within 90 days after the date on which the failure to properly use proceeds occurs; (2) if any nonqualified bonds of the issue are not redeemed within 90 days after the date on which the failure to properly use proceeds occurs (the unredeemed nonqualified bonds), a defeasance escrow is established for the unredeemed nonqualified bonds within 90 days after the date on which the failure to properly use proceeds occurs; or (3) if the failure to properly use proceeds is a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash, all of the disposition proceeds (as de-

fined in §1.141–12(c)(1)) are used within 90 days after the date of the disposition to redeem, or establish a defeasance escrow for, a *pro rata* portion of the nonqualified bonds of the issue.

The Temporary Regulations retain the remedial actions described in this preamble but, in accordance with new section 1397E(f)(3), the Temporary Regulations limit defeasance of nonqualified bonds to bonds the proceeds of which have actually been spent for a qualified purpose with respect to a qualified academy within the 5-year period beginning on the issue date of the bonds. For proceeds that have not been spent within the 5-year period, the only remedial action available to the issuer is redemption of nonqualified bonds under the principles of section 142.

3. *Failure to properly use proceeds*

For unspent proceeds, the 2004 Proposed Regulations provide that a failure to properly use proceeds occurs on the earlier of: (1) the first date on which the public school (or academic program within the public school) fails to constitute a qualified zone academy; or (2) the first date on which the issuer fails to have a reasonable expectation to proceed with due diligence to spend at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy.

The Temporary Regulations retain the provisions concerning the failure to properly use unspent proceeds but implement section 1397E(f)(1)(A) by adding a provision that improper use also occurs if 95 percent of the bond proceeds have not been properly spent within the 5-year period beginning on the day the bonds are issued.

For proceeds that have been spent for rehabilitation, repair or equipment described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, the 2004 Proposed Regulations provide that a failure to properly use proceeds occurs on the earlier of: (1) the first date on which the public school (or academic program within the public school) fails to constitute a qualified zone academy; and (2) the first date on which an action is taken that causes the issuer to fail actually to use at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy. If proceeds have been spent for course materials or training described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, no event subsequent to such expenditure shall constitute a failure to properly use such proceeds under the 2004 Proposed Regulations. The Temporary Regulations retain these provisions.

4. *Defeasance escrow*

The 2004 Proposed Regulations define "defeasance escrow" as an irrevocable escrow established to retire bonds on the earliest call date after the date on which the failure to properly use proceeds occurs in an amount that is sufficient to retire the bonds on that call date. At least 90 percent of the weighted average amount in a defeasance escrow must be invested in investments (as defined in §1.148–1(b)), except that no amount in a defeasance escrow may be invested in any investment the obligor (or any person that is a related party with respect to the obligor within the meaning of §1.150–1(b)) of which is a user of proceeds of the bonds. All purchases or sales of an investment in a defeasance escrow must be made at the fair market value of the investment within the meaning of §1.148–5(d)(6).

Under the 2004 Proposed Regulations, the issuer must pay to the United States, at the same time and in the same manner as rebate amounts are required to be paid under §1.148–3 (or at such other time or in such other manner as the Commissioner may prescribe), 100 percent of the investment earnings on amounts in the defeasance escrow. For this purpose, the first computation period begins on the date on which the failure to properly use proceeds occurs.

Under the 2004 Proposed Regulations, proceeds of QZABs (other than unspent proceeds of the issue for which the failure to properly use proceeds occurs) are not permitted to be used to redeem or defease the nonqualified bonds. In addition, the issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

Commentators suggested various modifications to the requirement that issuers rebate to the United States 100 percent of the investment earnings on amounts in a defeasance escrow. Alternative approaches suggested by commentators included: (1) limiting the rebate requirement to investment earnings in excess of the yield on the issue of QZABs; (2) limiting the rebate amount to investment earnings in excess of the total debt service requirements to be paid out of the defeasance escrow; and (3) limiting the rebate amount to the amount of the QZAB credit.

The IRS and Treasury Department have concluded that the rebate requirement should only apply to earnings in excess of the yield on the issue of QZABs. Thus, the Temporary Regulations provide that the issuer of QZABs with a defeasance escrow must rebate to United States any investment earnings in the defeasance escrow that are in excess of the yield, as defined in §1.148–1(b), on the issue of QZABs. For this purpose, the credit rate for the QZAB issue is not included in the yield on the issue.

Some commentators suggested that the first computation period for rebate purposes begin on the date the defeasance escrow is established, rather than the date on which the failure to properly use proceeds occurs. These commentators noted that the 2004 Proposed Regulations create a possible 90-day period during which an issuer would be required to compute yield on an escrow that is yet to be established. The Temporary Regulations adopt the change in start date for the computation period in accordance with this comment.

One commentator recommended that certain small, low-wealth local education agencies be exempt from the rebate requirement. The IRS and the Treasury Department have considered this recommendation and have concluded that the rebate requirement is appropriate to ensure compliance with the 95-percent use-of-proceeds requirement of section 1397E(d)(1)(A), regardless of the size or wealth of the local education agency. Thus, the Temporary Regulations do not adopt this recommendation.

Some commentators suggested that the regulations provide that a defeasance of a QZAB in the context of taking a remedial action not be treated as a significant modification (within the meaning of §1.1001–3) and reissuance of the QZAB. The Temporary Regulations do not address the circumstances in which a reissuance of a QZAB will occur. The Temporary Regulations do provide, how-

ever, that, for purposes of determining whether the establishing of a defeasance escrow as a remedial action results in an exchange under §1.1001–1(a), the QZAB is treated as a tax-exempt bond under §1.1001–3(e)(5)(ii)(B)(*1*). Section 1.1001–3(e)(5)(ii)(B)(*1*) provides that a defeasance of a tax-exempt bond is not a significant modification even if the issuer is released from any liability to make payments under the instrument if the defeasance occurs by operation of the terms of the original bond and the issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond.

5. *Alternative use of disposition proceeds*

The alternative use of disposition proceeds remedial action in the 2004 Proposed Regulations has four requirements. First, the failure to properly use proceeds must be a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition must be exclusively cash. Second, the issuer must reasonably expect as of the date of the disposition that: (1) all of the disposition proceeds, plus any amounts received from investing the disposition proceeds, will be spent within two years after the date of the disposition for a qualified purpose with respect to a qualified zone academy; or (2) to the extent not expected to be so spent, used within 90 days after the date of the disposition to take a redemption or defeasance remedial action. Third, the disposition proceeds, plus any amounts received from investing the disposition proceeds, must be treated as proceeds for purposes of section 1397E. Fourth, if all of the disposition proceeds, plus any amounts received from investing the disposition proceeds, are not actually spent for a qualified purpose within the two-year period beginning on the date of the disposition (or used within 90 days after the date of the disposition to take a redemption or defeasance remedial action), the remainder of such amounts must be used within 90 days after the end of that two-year period for a redemption or defeasance remedial action.

Some commentators recommended that the alternative use of disposition proceeds remedial action be modified to provide that the amounts relating to a disposition that are required to be spent for a qualified purpose be capped at the principal amount of the QZAB outstanding at the time of the disposition. The IRS and Treasury Department have considered this comment and have concluded that the requirement in the 2004 Proposed Regulations that all of the disposition proceeds, plus any amounts received from investing the disposition proceeds, be spent for a qualified purpose is appropriate to ensure that QZABs are issued for qualified purposes. Thus, the Temporary Regulations do not adopt this comment.

D. *Payment of principal, interest or redemption price*

The 2004 Proposed Regulations provide that the use of proceeds of a bond to pay principal, interest, or redemption price of the bond or another bond is not a qualified purpose within the meaning of section 1397E(d)(5). Thus, the use of proceeds of a bond to refund another bond is not a qualified purpose under the 2004 Proposed Regulations. In addition, the use of proceeds of a bond to fund a sinking fund to repay the bond is not a qualified purpose under the 2004 Proposed Regulations.

One commentator recommended that the 2004 Proposed Regulations be modified to permit proceeds of a QZAB to be used to repay an interim bridge loan incurred with the explicit intent to be refinanced with a subsequent issuance. In response to this comment, the Temporary Regulations provide an exception to the general rule that the use of proceeds of a bond to pay principal, interest, or redemption price of the bond or another bond is not a qualified purpose under section 1397E(d)(5).

IV. *Arbitrage Investment Restrictions*

New section 1397E(g) added by the 2006 Act provides that the arbitrage requirements of section 148 applicable to tax-exempt state or local governmental bonds under section 103 also apply to QZABs. The Temporary Regulations provide guidance regarding the application of the arbitrage requirements to QZABs.

In general, under section 148, subject to various prompt spending exceptions (for example, the 18-month prompt spending exception to arbitrage rebate for capital projects under §1.148–7(d) and the 2-year construction spending exception to arbitrage rebate under section 148(f)(4)(C) and §1.148–7(e)) and other specified exceptions (for example, the *bona fide* debt service exception for certain long-term tax-exempt governmental, non-private activity bonds under section 148(f)(4)(A)), the arbitrage investment restrictions, including the yield restrictions and the arbitrage rebate requirement, apply broadly to "gross proceeds" of tax-exempt bonds. "Gross proceeds" represents a broad catch-all category of bond proceeds which includes various subsidiary types of proceeds, including, among others, "sale proceeds" derived from the sale of bonds, "investment proceeds" derived from investing proceeds of bonds, and "replacement proceeds" with a reasonable nexus to a bond issue (for example, sinking funds reasonably expected to be used to pay debt service on bonds and pledged funds used to secure bonds).

The Temporary Regulations provide that, except as otherwise provided, the arbitrage investment restrictions under section 148 and the exceptions to those restrictions apply to gross proceeds of QZABs issued under section 1397E to the same extent and in the same manner as they apply to gross proceeds of tax-exempt state or local governmental bonds issued under section 103. For this purpose, references in the arbitrage restrictions to tax-exempt bonds generally shall be deemed to refer to QZABs and, to the extent that any particular arbitrage restriction depends on whether bonds are private activity bonds under section 141, the determination of whether QZABs are private activity bonds shall be based on the general definition of private activity bonds under section 141.

The Temporary Regulations provide limited guidance to tailor the application of the arbitrage investment restrictions to QZABs in certain specific respects. Thus, the Temporary Regulations provide that a five-year temporary period exception to the arbitrage yield restriction requirement applies to proceeds of QZABs if an issuer reasonably expects to spend 95 percent of the proceeds of an issue of QZABs for qualified purposes within the 5-year period beginning on the issue date of the QZABs.

The Temporary Regulations provide that, in determining the yield on an issue of QZABs for arbitrage purposes, the QZAB credit is disregarded. Here, yield focuses on yield paid by the issuer on the QZABs rather than the tax credit benefit to the investor.

The Temporary Regulations provide that the yield restriction rules are inapplicable to amounts placed in defeasance escrow as a remedial action. The Treasury Department and IRS have a concern that QZAB issuers may be unable to find appropriate investments of the amounts in the escrow at or below the yield on the bonds.

The Temporary Regulations provide that the exception to arbitrage yield restriction for certain investments in non-AMT tax-exempt bonds is inapplicable to QZABs. The IRS and the Treasury Department have a concern about the clear arbitrage investment potential associated with investing zero-yielding QZABs in non-AMT tax-exempt bond investments at materially higher yields.

The Temporary Regulations provide that, in determining whether an issue of QZABs qualifies for the small issuer exception to the arbitrage rebate requirement under section 148(f)(4)(D), both QZABs and tax-exempt bonds (other than private activity bonds) that are reasonably expected to be issued or actually issued by the QZAB issuer (and other covered on-behalf-of entities and subordinate entities) within a calendar year are taken into account in measuring the applicable size limitation.

Finally, consistent with the treatment of defeasance escrows for purposes of yield restriction, in applying the small issuer exception to the rebate of earnings from investments of amounts in a defeasance escrow, the Temporary Regulations provide that the issuer is not treated as a small issuer and amounts earned from such investments must be rebated to the United States.

V. *Information Reporting Requirement*

Issuers of QZABs must submit information reporting returns to the IRS similar to the information reporting returns required to be submitted to the IRS under section 149(e) for tax-exempt State or local bonds at the same time and manner as those reports are required to be submitted to the IRS on such forms as shall be prescribed by the Commissioner for such purpose.

Effective/Applicability Dates

In general, except as otherwise provided, the Temporary Regulations apply to bonds sold on or after September 14, 2007.

In general, except as otherwise provided, §1.1397E–1(h)(2), (i), and (j) of the Temporary Regulations regarding the five-year spending period, the arbitrage investment restrictions, and the information reporting requirement added by the 2006 Act apply to bonds issued pursuant to allocations of the national qualified zone academy bond volume cap authority arising in calendar years after 2005 and sold on or after September 14, 2007.

Issuers and taxpayers may apply the Temporary Regulations in whole, but not in part, to bonds sold before September 14, 2007.

Certain other special effective dates apply to particular provisions under §1.1397E–1T(m).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this Bulletin. 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.

Drafting Information

The principal authors of these regulations are Timothy L. Jones and Zoran Stojanovic, Office of Division Counsel/Associate Chief Counsel, IRS (Tax Exempt and Governmental Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1397E–1T also issued under 26 U.S.C. 1397E. * * *

Par. 2. Section 1.1397E–1 is amended by:

1. Redesignating paragraphs (i), (j) and (k) as (k), (l) and (m), respectively.

2. Adding new paragraphs (i) and (j).

3. Revising newly-designated paragraph (m).

The additions and revisions read as follows:

§1.1397E–1 Qualified zone academy bonds.

* * * * *

(i) and (j) [Reserved]. For further guidance, see §1.1397E–1T(i) and (j).

* * * * *

(m) *Effective/applicability dates*. Except as provided in this paragraph (m), this section applies, to bonds sold on or after September 26, 2000. Each of paragraphs (c) and (k) of this section may be applied by issuers to bonds that are sold before September 26, 2000.

Par. 3. Section 1.1397E–1T is added to read as follows:

§1.1397E–1T Qualified zone academy bonds (temporary).

(a) *In general*—(1) *Overview*. In general, a qualified zone academy bond (QZAB or QZABs) is a taxable bond issued by a state or local government the proceeds of which are used to improve certain eligible public schools. An eligible taxpayer that holds a QZAB generally is allowed annual Federal income tax credits in lieu of periodic interest payments. These credits compensate the eligible taxpayer for lending money to the issuer and function as payments of interest on the bond. Accordingly, this section generally treats the allowance of a credit as if it

were a payment of interest on the bond. This section also provides other rules for QZABs, including rules governing the credit rate, the private business contribution requirement, the maximum term, use and expenditure of proceeds, remedial actions, eligible issuers, arbitrage investment restrictions, and information reporting.

(2) *Certain definitions*—(i) *In general*. For purposes of this section, except as otherwise provided in this section, the following definitions apply: the definitions set forth in this section; the definitions used for general tax-exempt bond purposes in §1.150–1; and the definitions used for purposes of the arbitrage investment restrictions on tax-exempt bonds in §1.148–1(b).

(ii) *Applicable definition of proceeds*—(A) *Use and expenditure provisions*. Except as provided in paragraphs (a)(2)(ii)(B) and (a)(2)(ii)(C) of this section, for purposes of all applicable requirements regarding use and expenditure of proceeds of QZABs under section 1397E and this section, proceeds means "sale proceeds," as defined in §1.148–1(b), plus "investment proceeds," as defined in §1.148–1(b).

(B) *Private business contribution requirement*. For purposes of the private business contribution requirement of section 1397E(d)(2), proceeds means "sale proceeds," as defined in §1.148–1(b).

(C) *Arbitrage investment restrictions*. For purposes of the scope of application of the arbitrage investment restrictions under section 1397E(g) and paragraph (i) of this section, proceeds generally means gross proceeds, as defined in §1.148–1(b). In addition, in applying the arbitrage investment restrictions under paragraph (i) of this section and section 148, the various applicable definitions of the various types of proceeds of tax-exempt bonds under §1.148–1(b) shall apply.

(b) and (c) [Reserved]. For further guidance, see §1.1397E–1(b) and (c).

(d) *Maximum term*. The maximum term for a QZAB is determined under section 1397E(d)(3) by using a discount rate equal to 110 percent of the long-term adjusted applicable Federal rate (AFR), compounded semi-annually, for the month in which the bond is sold. The Internal Revenue Service publishes this figure each month in a revenue ruling that is published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(*b*) of this chapter. A bond is sold on the sale date, as defined in §1.150–1(c)(6), which is the first day on which there is a binding contract in writing for the sale or exchange of the bond.

(e) through (g) [Reserved]. For further guidance, see §1.1397E–1(e) through (g).

(h) *Use of proceeds*—(1) *In general*. Section 1397E(d)(1) provides that a bond issued as part of an issue is a QZAB only if, among other requirements, at least 95 percent of the proceeds of the issue are to be used for a qualified purpose with respect to a qualified zone academy established by an eligible local education agency (as defined in section 1397E(d)(4)(B)), and the issue meets the requirements of section 1397E(f) and (g). Section 1397E(d)(5) defines *qualified purpose*, with respect to any qualified zone academy, as rehabilitating or repairing the public school facility in which such academy is established, providing equipment for use at such academy, developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. Section 1397E(d)(4)(A) defines *qualified zone academy* as any public school (or academic program within a public school) that is established by and operated under the supervision of an eligible local education agency to provide education or training below the postsecondary level and that meets the requirements of section 1397E(d)(4)(A)(i), (ii), (iii) and (iv).

(2) *Use of proceeds requirements*. An issue meets the requirements of sections 1397E(d)(1)(A) and (f) only if—

(i) The issuer reasonably expects, as of the issue date of the issue, that—

(A) At least 95 percent of the proceeds from the sale of the issue are to be spent for 1 or more qualified purposes with respect to qualified zone academies within the 5-year period beginning on the issue date of the QZAB;

(B) A binding commitment with a third party to spend at least 10 percent of the proceeds from the sale of the issue will be incurred within the 6-month period beginning on the issue date of the QZAB;

(C) At least 95 percent of the proceeds from the sale of the issue will be spent for a qualified purpose with respect to a qualified zone academy with due diligence (with due diligence measured by the reasonableness standard under §1.148–1(b); and

(D) At least 95 percent of the proceeds of the issue will be used for a qualified purpose with respect to a qualified zone academy for the entire term of the issue (without regard to any redemption provision); and

(ii) Except as otherwise provided in paragraph (h)(7) of this section, at least 95 percent of the proceeds of the issue are actually used for a qualified purpose with respect to a qualified academy for the entire term of the issue (without regard to any redemption provision).

(iii) *Extension of 5-year period*. The Commissioner may extend the period described in paragraph (h)(2)(i)(A) of this section if the issuer, prior to the end of such period, submits a private ruling request, and establishes to the satisfaction of the Commissioner that—

(A) The failure to satisfy the 5-year spending requirement is due to reasonable cause; and

(B) The expenditure of at least 95 percent of the proceeds from the sale of the issue for a qualified purpose with respect to a qualified zone academy will continue to proceed with due diligence.

(3) *Unspent proceeds*. For purposes of paragraphs (h)(2)(i)(D) and (h)(2)(ii) of this section, during the period described in paragraph (h)(2)(i)(A) of this section, including any extension under paragraph (h)(2)(iii) of this section, unspent proceeds are treated as used for a qualified purpose with respect to a qualified zone academy if the issuer reasonably expects to proceed with due diligence to spend those proceeds for a qualified purpose with respect to a qualified zone academy during that period.

(4) *Proceeds spent for rehabilitation, repair or equipment*—(i) *In general*. Under section 1397E(d)(5)(A), the term *qualified purpose* with respect to any qualified zone academy includes rehabilitating or repairing the public school facility in which such academy is established. For this purpose, in determining whether proceeds are spent for rehabilitation, rules similar to those under section 47(c) (other than sections 47(c)(1)(B) and 47(c)(2)(B)(iv)) shall apply. Under section 1397E(d)(5)(B), the term *qualified purpose* also includes providing equipment for use at such academy. If proceeds of an issue are spent for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy,

then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure that—

(A) The property financed with those proceeds is used for the purposes of the academy; and

(B) The academy maintains its status as a qualified zone academy under section 1397E(d)(4).

(ii) *Retirement from service*. The retirement from service of financed property due to normal wear or obsolescence does not cause the property to fail to be used for a qualified purpose with respect to a qualified zone academy.

(5) *Proceeds spent to develop course materials or train teachers*. Section 1397E(d)(5)(C) and (D) provides that the term *qualified purpose* with respect to any qualified zone academy includes developing course materials for education to be provided at such academy, and training teachers and other school personnel in such academy. If proceeds of an issue are spent for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, then those proceeds are treated as used for a qualified purpose with respect to the academy during any period after such expenditure.

(6) *Special rule for determining status as qualified zone academy*. Section 1397E(d)(4)(A)(iv) provides that a public school (or academic program within a public school) is a qualified zone academy only if, among other requirements, the public school is located in an empowerment zone or enterprise community (as defined in section 1393), or there is a reasonable expectation (as of the issue date of the issue) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act. For purposes of determining whether an issue complies with section 1397E(d)(4)(A)(iv)—

(i) A public school is treated as located in an empowerment zone or enterprise community for the entire term of the issue if the public school is located in an empowerment zone or enterprise community on the issue date of the issue; and

(ii) The determination of whether there is a reasonable expectation (as of the issue date of the issue) that at least 35 percent of the students attending the school or participating in the program (as the case may be) will be eligible for free or reduced-cost lunches under the school lunch program established under the Richard B. Russell National School Lunch Act is based on expectations regarding the one-year period following the issue date.

(7) *Remedial actions*—(i) *General rule*. If less than 95 percent of the proceeds of an issue are properly used (as determined under paragraph (h)(7)(ii)(D) of this section), the issue will be treated as meeting the requirements of section 1397E(d)(1)(A) if the issue met the requirements of paragraph (h)(2)(i) of this section and a remedial action is taken under paragraph (h)(7)(ii) or (iii) of this section.

(ii) *Redemption or defeasance*—(A) *In general*. A remedial action is taken under this paragraph (h)(7)(ii) if the requirements of paragraphs (h)(7)(ii)(B) and (C) of this section are met.

(B) *Retirement of nonqualified bonds*—(*1*) *In general*. The requirements of this paragraph (h)(7)(ii)(B) are met if—

(*i*) All of the nonqualified bonds of the issue (determined by applying the principles of §1.142–2(e)) are redeemed within 90 days after the date on which the failure to properly use proceeds occurs; or

(*ii*) To the extent of proceeds of the issue that have been actually spent for a qualified purpose with respect to a qualified zone academy, if any nonqualified bonds of the issue are not redeemed within 90 days after the date on which the failure to properly use such proceeds occurs (the unredeemed nonqualified bonds), a defeasance escrow is established for the unredeemed nonqualified bonds within 90 days after the date on which the failure to properly use proceeds occurs.

(*2*) *Special rule for dispositions for cash*. If the failure to properly use proceeds is a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash, the requirements of this paragraph (h)(7)(ii)(B) are met if all of the disposition proceeds (as defined in paragraph (h)(7)(iv) of this section) are used within 90 days after the date of the disposition to redeem, or establish a defeasance escrow for, a *pro rata* portion of the nonqualified bonds of the issue.

(*3*) *Definition of defeasance escrow*. For purposes of this section, a defeasance escrow is an irrevocable escrow established to retire nonqualified bonds on the earliest call date after the date on which the failure to properly use proceeds occurs in an amount that is sufficient to retire nonqualified bonds on that call date. At least 90 percent of the weighted average amount in a defeasance escrow must be invested in investments (as defined in §1.148–1(b)), except that no amount in a defeasance escrow may be invested in any investment the obligor (or any person that is a related party with respect to the obligor within the meaning of §1.150–1(b)) of which is a user of proceeds of the bonds. All purchases or sales of an investment in a defeasance escrow must be made at the fair market value of the investment within the meaning of §1.148–5(d)(6).

(C) *Additional rules*—(*1*) *Limitation on source of funding*. Proceeds of an issue of QZABs (other than unspent proceeds of the issue for which the failure to properly use proceeds occurs) must not be used to redeem or defease nonqualified bonds under paragraph (h)(7)(ii)(B) of this section.

(*2*) *Rebate requirement*. The issuer must pay to the United States, at the same time and in the same manner as rebate amounts are required to be paid under §1.148–3 (or at such other time or in such other manner as the Commissioner may prescribe), any investment earnings on amounts in a defeasance escrow established under paragraph (h)(7)(ii)(B) of this section that are in excess of the yield on the issue of QZABs with respect to which the defeasance escrow was established. For this purpose, the first computation period begins on the date on which the defeasance escrow is established.

(*3*) *Notice of defeasance*. The issuer must provide written notice to the Commissioner, at the place designated in §1.150–5(a), of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

(D) *When a failure to properly use proceeds occurs*—(*1*) *Unspent proceeds*. For unspent proceeds, a failure to properly use proceeds occurs on the earlier of—

(*i*) The first date on which the public school (or academic program within the public school) fails to constitute a qualified zone academy;

(*ii*) The first date on which the issuer fails to have a reasonable expectation to proceed with due diligence to spend at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy; or

(*iii*) The last day of the period described in paragraph (h)(2)(i)(A) of this section, including any extension, if less than 95 percent of the proceeds of the issue are actually spent for a qualified purpose with respect to a qualified zone academy.

(*2*) *Proceeds spent for rehabilitation, repair or equipment*. For proceeds that have been spent for a purpose described in section 1397E(d)(5)(A) or (B) with respect to a qualified zone academy, a failure to properly use proceeds occurs on the earlier of—

(*i*) The first date on which the public school (or academic program within the public school) fails to constitute a qualified zone academy; and

(*ii*) The first date on which an action is taken that causes the issuer to fail actually to use at least 95 percent of the proceeds of the issue for a qualified purpose with respect to a qualified zone academy.

(*3*) *Proceeds spent for course materials or training*. If proceeds have been spent for a purpose described in section 1397E(d)(5)(C) or (D) with respect to a qualified zone academy, no event subsequent to such expenditure shall constitute a failure to properly use such proceeds.

(iii) *Alternative use of disposition proceeds*. A remedial action is taken under this paragraph (h)(7)(iii) if all of the requirements of paragraphs (h)(7)(iii)(A) through (D) of this section are met—

(A) The failure to properly use proceeds (as determined under paragraph (h)(7)(ii)(D) of this section) is a disposition of financed property described in section 1397E(d)(5)(A) or (B) and the consideration for the disposition is exclusively cash;

(B) The issuer reasonably expects as of the date of the disposition that—

(*1*) All of the disposition proceeds will be spent within the two-year period beginning with the date of the disposition for a qualified purpose with respect to a qualified zone academy; or

(*2*) To the extent not expected to be so spent, the disposition proceeds will be used within 90 days after the date of the disposition to redeem or defease bonds in a manner that meets the requirements of paragraph (h)(7)(ii) of this section;

(C) The disposition proceeds are treated as proceeds for purposes of section 1397E; and

(D) If all of the disposition proceeds are not actually used in the manner described in paragraph (h)(7)(iii)(B) of this section, the remainder of such amounts are used within 90 days after the end of the period described in paragraph (h)(7)(iii)(B)(*1*) of this section for a remedial action that meets the requirements of paragraph (h)(7)(ii) of this section.

(iv) *Definition of disposition proceeds and allocation among multiple funding sources*. For purposes of this paragraph (h)(7), *disposition proceeds* means disposition proceeds, as defined in §1.141–12(c)(1), plus amounts derived from investing disposition proceeds. If property has been financed with an issue of QZABs and one or more other funding sources, any disposition proceeds from that property are allocated to the issue under the principles of §1.141–12(c)(3).

(8) *Payment of principal, interest or redemption price*—(i) *In general*. Except as provided in paragraphs (h)(8)(ii) and (h)(8)(iii) of this section, the use of proceeds of a bond to pay principal, interest, or redemption price of the bond or another bond is not a qualified purpose within the meaning of section 1397E(d)(5).

(ii) *Exception for certain eligible reimbursements of interim refinancings*. The use of proceeds of a bond (the refinancing bond) to pay principal, interest or redemption price of another bond (the prior bond) is a qualified purpose within the meaning of section 1397E(d)(5) to the extent that—

(A) The prior bond was not a QZAB (and, in the case of a series of refinancings, no earlier bond in the series was a QZAB);

(B) The proceeds of the prior bond (or the original bond in the case of a series of refinancings, as applicable) were spent for a qualified purpose under section 1397E(d)(5) (the original expenditure); and

(C) The issuer makes a valid reimbursement allocation to allocate the proceeds of the refinancing bond to the payment of the original expenditure (the reimbursement allocation), which allocation satisfies the requirements for reimbursements under paragraph (h)(9) of this section. For purposes of applying the rules for reimbursement, a refinancing bond which otherwise meets the requirements of this paragraph (h)(8)(ii) is eligible for reimbursement and is not treated as a disqualified refunding under §1.150–2(g).

(iii) *Reissuance of a QZAB*. For purposes of determining whether the establishing of a defeasance escrow under paragraph (h)(7)(ii)(B)(*1*)(*ii*) of this section results in an exchange under §1.1001–1(a), the QZAB is treated as a tax-exempt bond under §1.1001–3(e)(5)(ii)(B)(*1*).

(9) *Reimbursement*. An expenditure for a qualified purpose may be reimbursed with proceeds of a QZAB. For this purpose, rules similar to those on reimbursement of expenditures in §1.142–4(b) and §1.150–2 shall apply. In applying these reimbursement rules, expenditures eligible for reimbursement under §1.150–2(d)(3) shall be deemed to mean any expenditure for a qualified purpose under section 1397E(d)(5).

(i) *Arbitrage investment restrictions*—(1) *In general*. Under section 1397E(g) and this paragraph (i), and except as otherwise provided in this paragraph (i), the arbitrage investment restrictions and rebate requirements under section 148 and §1.148–1 to §1.148–11, inclusive, and the exceptions to those restrictions, apply broadly to gross proceeds of QZABs issued under section 1397E to the same extent and in the same manner as they apply to gross proceeds of tax-exempt state or local governmental bonds. For this purpose, references in those sections to tax-exempt bonds generally shall be deemed to refer to QZABs and, to the extent that any particular arbitrage restriction depends on whether bonds are private activity bonds under section 141, the determination of whether QZABs are private activity bonds shall be based on the general definition of private activity bonds under section 141. In applying section 148 and the regulations under that section to QZABs, the modifications set forth in paragraphs (i)(2) through (6) of this section shall apply.

(2) *5-year temporary period exception to arbitrage yield restriction*. If an issue of QZABs meets the requirements of section 1397E(f)(1) and paragraph (h)(2)(i) of this section, then the proceeds of the issue of QZABs are treated as qualifying for a 5-year temporary period exception to arbitrage yield restriction under

§1.148–2(e)(2) beginning on issue date of the issue.

(3) *Disregard QZAB credit in QZAB yield for arbitrage purposes*. In determining the yield on an issue of QZABs for arbitrage purposes under §1.148–4, the QZAB credit allowed under section 1397E(a) is disregarded.

(4) *Non-AMT tax-exempt bond investment exception inapplicable*. The exception to arbitrage yield restriction for investments of gross proceeds of tax-exempt bonds in specified tax-exempt bond investments not subject to section 148(b)(3)(B) (relating to an exception to the definition of "investment property" for specified tax-exempt bonds) and §1.148–2(d)(2)(v) (relating to a corresponding exception to arbitrage yield limitations) is inapplicable.

(5) *Application of small issuer exception to the arbitrage rebate requirement*. Except as otherwise provided in paragraph (i)(6) of this section, for purposes of the small issuer exception to the arbitrage rebate requirement under section 148(f)(4)(D) and §1.148–8, both QZABs and tax-exempt bonds (other than private activity bonds) that are actually issued or reasonably expected to be issued by the QZAB issuer (and applicable entities aggregated under section 148(f)(4)(D)) within a calendar year are taken into account in measuring the applicable size limitation.

(6) *Certain defeasance escrow earnings*. With respect to a defeasance escrow established in a remedial action for an issue of QZABs that meets the special rebate requirement under paragraph (h)(7)(ii)(C)(*2*) of this section, the QZAB issuer is treated as ineligible for the small issuer exception to arbitrage rebate under section 148(f)(4)(D) and paragraph (i)(5) of this section and compliance with that special rebate requirement is treated as satisfying applicable arbitrage investment restrictions under section 148 for that defeasance escrow.

(j) *Information reporting requirement*. Under section 1397E(h) and this paragraph (j), issuers of QZABs are required to submit information reporting returns to the IRS similar to the information reporting returns required to be submitted to the IRS under section 149(e) for tax-exempt state or local governmental bonds at the same time and in the same manner as those reports are required to be submitted to the IRS on such forms as shall be prescribed by the Commissioner for such purpose.

(k) and (l) [Reserved]. For further guidance, see §1.1397E–1(k) and (l).

(m) *Effective/applicability dates*—(1) *In general*. Except as otherwise provided in this paragraph (m), this section applies to bonds sold on or after September 14, 2007.

(2) *Special effective dates*—(i) *Effective dates for paragraphs (h)(2), (i), and (j) of this section in general*. Paragraphs (h)(2), (i), and (j) of this section apply to bonds issued pursuant to allocations of the national qualified zone academy bond volume cap authority for calendar years after 2005 and sold on or after September 14, 2007.

(ii) *Permissive retroactive application*—(A) *In general*. Except as otherwise provided in this paragraph (m), issuers and taxpayers may apply this section in whole, but not in part, to bonds sold before September 14, 2007.

(B) *Special rule for certain provisions*. For purposes of the permissive retroactive application rule in paragraph (m)(2)(ii)(A) of this section, paragraphs (h)(2), (i), and (j) of this section need not be applied to any bonds to which those provisions do not otherwise apply under the general effective date provisions for those provisions in paragraph (m)(2)(i) of this section.

(C) *Definition of proceeds*. Issuers and taxpayers may apply paragraphs (d) and (h) of this section, without regard to the definition of proceeds in paragraph (a)(2)(ii) of this section, to bonds sold before September 14, 2007.

(D) *Bonds issued before July 1, 1999*. Paragraphs (d) and (h)(9) of this section may not be applied to bonds issued before July 1, 1999.

(3) *Expiration date*. The applicability of this section expires on or before July 13, 2010.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (b) is amended by adding the following entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1397E–1T	1545–1908
* * * * *	

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

Approved July 3, 2007.

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

(Filed by the Office of the Federal Register on July 13, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 16, 2007, 72 F.R. 38767)

Section 1502.—Regulations

26 CFR 1.1502–19: Excess loss accounts.

T.D. 9341

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Treatment of Excess Loss Accounts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations under section 1502. Section 1.1502–19(d) governs basis determinations and adjustments of subsidiary stock in certain transactions involving members of a consolidated group. Section 1.1502–80(c) governs the determination of when subsidiary stock is treated as worthless under section 165. These final regulations affect affiliated groups of corporations filing consolidated returns.

DATES: *Effective Date:* These final regulations are effective on July 18, 2007.

Applicability Dates: Section 1.1502–19(d) applies to transactions occurring on or after July 18, 2007. Section 1.1502–80(c) applies to taxable years for which the original consolidated Federal income tax return is due (without extensions) after July 18, 2007.

FOR FURTHER INFORMATION CONTACT: For questions regarding §1.1502–19(d), contact Theresa M. Kolish, (202) 622–7530 (not a toll-free number). For questions regarding §1.1502–80(c), contact Theresa Abell, (202) 622–7700 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 26, 2006, the IRS and Treasury Department published a notice of proposed rulemaking (REG–138879–05, 2006–1 C.B. 503 [71 FR 4319]) by cross-reference to a temporary regulation under §1.1502–19 (T.D. 9244, 2006–1 C.B. 463 [71 FR 4264]). Prior to the publication of the proposed and temporary regulations, the direction of a transaction determined whether an excess loss account would be reduced or eliminated. For example, if P had owned all the stock of S with an excess loss account of $100 and all of the stock of T with a basis of $150, and T had merged into S in a reorganization described in section 368(a)(1)(D) in which P received additional shares of S stock, under §1.1502–19(d), P's excess loss account in its original shares of S stock was first eliminated. Therefore, P's original S shares would have had an aggregate basis of $0 and P's new S shares would have had an aggregate basis of $50. However, if S instead had merged into T in a reorganization described in section 368(a)(1)(D) in which P received additional shares of T stock, §1.1502–19(d) would not have applied because P did not already have T shares with an excess loss account. Therefore, P's original T shares would have had a basis of $150 and P's new T shares would have had an excess loss account of $100.

The IRS and Treasury Department found the electivity of the rule based on the direction of the transaction to be undesirable. Accordingly, the IRS and Treasury Department added §1.1502–19T(d), which provides that, if a member would otherwise determine shares of a class of S's stock (a new share) to have an excess loss account and such member owns one or more other shares of the same class of S's stock, the basis of such other shares is allocated to eliminate and equalize any excess loss account that would otherwise be in the new shares.

No public hearing regarding the proposed regulation was requested or held. However, a few informal comments regarding the proposed and temporary regulations were received. In particular, the commentators noted that §1.1502–19T(d) would appear to apply in the earlier example if P had excess loss accounts in its shares of both S and T. For example, assume that P owned S and T (which were of equal value), P had a $50 excess loss account in its S stock and a $100 excess loss account in its T stock, and T merged into S in a reorganization described in section 368(a)(1)(D) in which additional shares were issued. Under §1.1502–19T(d), the excess loss accounts in the two blocks of S stock would be equalized so that P would have a $75 excess loss account in each block. The commentators asked whether this outcome was intended. The IRS and Treasury Department believe that the excess loss accounts in this example should be equalized and affirm that §1.1502–19 does apply under the facts presented. This application eliminates the disparity between excess loss accounts in order to better reflect P's investment in its subsidiary stock. The proposed regulation under §1.1502–19 is adopted by this Treasury decision and the temporary regulation is removed.

Additionally, on January 23, 2007, the IRS and Treasury Department published a notice of proposed rulemaking (REG–157711–02, 2007–8 I.R.B. 537 [72 FR 2964]) under §1.1502–80(c) regarding when the stock of a member is treated as worthless under section 165. The proposed regulation is adopted without substantive modification by this Treasury Decision, and is applicable to tax years for which the original consolidated Federal income tax return is due (without extensions) after July 18, 2007. Section 1.1502–80T is removed.

Consistent with the prior final regulations, these regulations provide that subsidiary stock is not treated as worthless before the earlier of the time that the subsidiary ceases to be a member of the group or the time that the stock of the subsidiary is worthless within the meaning of §1.1502–19(c)(1)(iii). Section 1.1502–19(c)(1)(iii) identifies three separate events that cause a share of subsidiary stock to be treated as worthless and therefore disposed of for purposes of taking into account an excess loss account in the share. Section 1.1502–19(c)(1)(iii)(A) applies when the subsidiary disposes of substantially all of its assets, and the deferral of any worthless securities deduction until that time implements single-entity principles. While an event identified in either §1.1502–19(c)(1)(iii)(B) or (C) (generally dealing with debt cancellations) will likely occur in connection with an event identified in §1.1502–19(c)(1)(iii)(A), either may occur independently. In light of the single-entity purpose of the regulations, the IRS and Treasury Department are requesting comments regarding whether

these regulations should refer only to the time stock is treated as worthless within the meaning of §1.1502–19(c)(1)(iii)(A).

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. Pursuant to 5 U.S.C. 553(d)(3) it has been determined that a delayed effective date is unnecessary because this rule finalizes currently effective temporary rules regarding the treatment of excess loss accounts without substantive change. It is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notices of proposed rulemaking preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of §1.1502–19 is Theresa M. Kolish of the Office of the Associate Chief Counsel (Corporate), IRS. The principal author of §1.1502–80(c) is Theresa Abell of the Office of the Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for §§1.1502–19T and 1.1502–80T to read in part as follows:

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

Section 1.1502–19 and §1.1502–80 are also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502–19 is amended by revising paragraphs (d), (g) and (h)(2)(iv) to read as follows:

§1.1502–19 Excess loss accounts.

* * * * *

(d) *Special allocation of basis in connection with an adjustment or determination*—(1) *Excess loss account in original shares*. If a member has an excess loss account in shares of a class of S's stock at the time of a basis adjustment or determination under the Internal Revenue Code with respect to shares of the same class of S's stock owned by the member, the adjustment or determination is allocated first to equalize and eliminate that member's excess loss account. See §1.1502–32(c) for similar allocations of investment adjustments to prevent or eliminate excess loss accounts.

(2) *Excess loss account in new S shares*. If a member would otherwise determine shares of a class of S's stock (new shares) to have an excess loss account and such member owns one or more other shares of the same class of S's stock, the basis of such other shares is allocated to eliminate and equalize any excess loss account that would otherwise be in the new shares.

* * * * *

(g) * * *

Example 2. Basis determinations under the Internal Revenue Code in intercompany reorganizations—transfer of shares without an excess loss account. (i) *Facts*. P owns all of the sole class of stock of each of S and T. P has 150 shares of S stock that it acquired on Date 1. Each S share has a $1 basis and a fair market value of $1. P has 100 shares of T stock that it acquired on Date 2. Each T share has a $1.20 excess loss account and a fair market value of $1. P transfers S's stock to T without receiving additional T stock. The transfer is an exchange described in both section 351 and section 354.

(ii) *Analysis*. Under sections 351 and 354, P does not recognize gain in connection with the transfer. Under §1.358–2(a)(2)(iii), P is deemed to receive 150 shares of T stock of the same class. Without regard to the application of paragraph (d) of this section, under section 358 and §1.358–2(a)(2)(i), P would have a $1 basis in each such share. However, because the basis of the additional shares of T stock will be determined when P has an excess loss account in its original shares of T stock, under paragraph (d)(1) of this section, the basis that P would otherwise have in such additional shares will eliminate the excess loss account in P's original shares of T stock such that each original share of T stock will have a basis of $0 and each share of T stock deemed received will have a basis of $0.20. Then, under §1.358–2(a)(2)(iii), the T stock is deemed to be recapitalized in a reorganization under section 368(a)(1)(E) in which P receives 100 shares of T stock (those shares P actually owns immediately after the transfer) in exchange for those 100 shares of T stock that P held immediately prior to the transfer and those 150 shares of T stock P is deemed to receive in the transfer. Under §1.358–2(a)(2)(i), immediately after the transfer, P holds 100 shares of T stock, 60 of which take a basis of $0.50 each and 40 of which take a basis of $0 each. In addition, T takes a $1 basis in each share of S stock under section 362. (If P had actually received an additional 150 shares of T stock of the same class, paragraph (d)(1) of this section would apply to shift basis from such additional T shares to P's original T shares because the basis of the additional T stock would be determined when P had an excess loss account in its original T shares. P would have a basis of $0 in each of the original T shares and a basis of $0.20 in each of the additional T shares.)

(iii) *Transfer of shares with an excess loss account*. The facts are the same as in paragraph (i) of this *Example 2*, except that P transfers T's stock to S without receiving additional S stock. The transfer is an exchange described in both section 351 and section 354. Under paragraph (c) of this section, P's transfer is treated as a disposition of T's stock. Under sections 351 and 354 and paragraph (b)(2) of this section, P does not recognize gain from the disposition. Under §1.358–2(a)(2)(iii), P is deemed to have received 100 shares of S stock of the same class. Without regard to the application of paragraph (d) of this section, P would have a $1.20 excess loss account in each such share. However, because P will have an excess loss account in such shares and P owns other shares of S stock of the same class, under paragraph (d)(2) of this section, the excess loss account that P would otherwise have in such shares will decrease P's basis in its original shares of S's stock such that each such original share will have a basis of $0.20 and each share deemed received will have a basis of $0. Then, under §1.358–2(a)(2)(iii), the S stock is deemed to be recapitalized in a reorganization under section 368(a)(1)(E) in which P receives 150 shares of S stock (those shares P actually owns immediately after the transfer) in exchange for those 150 shares of S stock that P held immediately prior to the transfer and those 100 shares of S stock that P is deemed to receive in connection with the transfer. Under §1.358–2(a)(2)(i), immediately after the transfer, P holds 150 shares of S stock, 90 of which take a basis of $0.33 each and 60 of which take a basis of $0 each. In addition, S takes an excess loss account of $1.20 in each share of T stock under section 362. (If P had actually received 100 additional shares of S stock of the same class, paragraph (d)(2) of this section would apply to shift basis from P's original S stock because P would have otherwise had an excess loss account in such additional shares and P owned other shares of S stock of the same class. The excess

loss account that P would have otherwise had in such additional shares would have decreased P's basis in its original shares of S's stock. P would have had a basis of $0.20 in each of the original shares and a basis of $0 in each of the additional shares.)

(iv) *Intercompany merger—shares with excess loss account retained*. The facts are the same as in paragraph (i) of this *Example 2*, except that S merges into T in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)), and P receives 150 additional shares of T stock of the same class in the reorganization. Under section 354, P does not recognize gain. Without regard to the application of paragraph (d) of this section, under section 358 and §1.358–2(a)(2)(i), P would have a $1 basis in each such share. However, because the basis of the additional shares of T stock will be determined when P has an excess loss account in its original shares of T stock, under paragraph (d)(1) of this section, the basis that P would otherwise have in such additional shares eliminates the excess loss account in P's original shares of T stock such that each original share of T stock has a basis of $0 and each additional share of T stock has a basis of $0.20.

(v) *Intercompany merger—shares with excess loss account surrendered*. The facts are the same as in paragraph (i) of this *Example 2*, except that T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)), and P receives 100 additional shares of S stock of the same class in the reorganization. Under section 354 and paragraph (b)(2) of this section, P does not recognize gain from the disposition. Without regard to the application of paragraph (d) of this section, under section 358 and §1.358–2(a)(2)(i), P would have a $1.20 excess loss account in each additional share of S stock received. However, because P would have an excess loss account in such shares and P owns other shares of S stock of the same class, under paragraph (d)(2) of this section, the excess loss account that P would otherwise have in such shares decreases P's basis in its original shares of S's stock such that each original share of S stock has a basis of $0.20 and each additional share of S stock has a basis of $0.

* * * * *

(h) * * *

(2)(iv) *Intercompany reorganizations*. Paragraphs (d) and (g) *Example 2* of this section apply to transactions occurring on or after July 18, 2007. For transactions occurring on or after January 23, 2006, and before July 18, 2007, see §1.1502–19T as contained in 26 CFR part 1 in effect April 1, 2007. For transactions occurring before January 23, 2006, see §1.1502–19 as contained in 26 CFR part 1 in effect April 1, 2005.

* * * * *

§1.1502–19T [Removed]

Par. 3. Section 1.1502–19T is removed.

Par. 4. Section 1.1502–80 is amended by revising paragraph (c) to read as follows:

§1.1502–80 Applicability of other provisions of law.

* * * * *

(c) *Deferral of section 165*—(1) *General rule*. Subsidiary stock is not treated as worthless under section 165 until immediately before the earlier of the time—

(i) The stock is worthless within the meaning of §1.1502–19(c)(1)(iii); or

(ii) The subsidiary for any reason ceases to be a member of the group.

(2) *Cross reference*. See §§1.337(d)–2 and 1.1502–35 for additional rules relating to loss on subsidiary stock.

(3) *Effective/applicability date*. This paragraph (c) applies to taxable years for which the original consolidated Federal income tax return is due (without extensions) after July 18, 2007. However, taxpayers may apply this paragraph (c) to taxable years beginning on or after January 1, 1995.

* * * * *

§1.1502–80T [Removed]

Par. 5. Section 1.1502–80T is removed.

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

Approved July 10, 2007.

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

(Filed by the Office of the Federal Register on July 17, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 18, 2007, 72 F.R. 39313)

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26 CFR 1.1502–47: Consolidated returns by life-nonlife groups.

T.D. 9342

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Guidance Under Section 1502; Amendment of Tacking Rule Requirements of Life-Nonlife Consolidated Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations under section 1502 concerning the requirements for including insurance companies in a life-nonlife consolidated return. These regulations conform the consolidated return rules to certain changes in law. These regulations affect corporations filing life-nonlife consolidated returns.

DATES: *Effective Date:* These regulations are effective July 20, 2007.

Applicability Date: For dates of applicability, see §§1.1502–47(b) and 1.1502–76(d).

FOR FURTHER INFORMATION CONTACT: Ross Poulsen (202) 622–7790 or Marcie Barese (202) 622–7790 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1504(c) of the Internal Revenue Code permits life companies to join in the filing of a consolidated return with nonlife corporations with certain restrictions, the principal one of which is that a life company must be a member of the affiliated group (without regard to section 1504(b)(2)) for five taxable years before it may join in the filing of the consolidated group's return. Section 1.1502–47 contains an exception to this requirement (the tacking rule) for transactions that meet certain conditions. The original tacking rule contained five conditions, including "the separation condition."

Before 1981, section 843 required all insurance companies taxed under Subchapter L to adopt a calendar year tax year. The consolidated return regulations required all members of a consolidated group to adopt the tax year of the common parent, but, in order to accommodate section 843, required a fiscal-year consolidated group to change its tax year to a

calendar year if, on the last day of its fiscal year, it included an insurance company required by section 843 to use a calendar year (Old §1.1502–76(a)(2)). In 1981, an amendment to section 843 became effective, providing that, under regulations prescribed by the Secretary, an insurance company joining in the filing of a consolidated return may adopt the fiscal year of the common parent corporation.

On April 25, 2006, temporary regulations (T.D. 9258, 2006–1 C.B. 886) were published in the **Federal Register** (71 FR 23856) amending the tacking rule of the life-nonlife consolidated return regulations and the regulations relating to taxable years of members of a consolidated group. A notice of proposed rulemaking (REG–133036–05, 2006–1 C.B. 911) cross-referencing those temporary regulations was published in the **Federal Register** (71 FR 23882) on the same day. The temporary regulations removed the separation condition of the tacking rule and Old §1.1502–76(a)(2).

On May 30, 2006, temporary regulations (T.D. 9264, 2006–1 C.B. 1150) were published in the **Federal Register** (71 FR 30591), in part, amending the regulations relating to taxable years of members of a consolidated group. A notice of proposed rulemaking (REG–134317–05, 2006–1 C.B. 1184) cross-referencing those temporary regulations was published in the **Federal Register** (71 FR 30640) on the same day. The temporary regulations eliminated impediments to the electronic filing of the statement made under §1.1502–76(b)(2)(ii).

The IRS and Treasury Department considered several comments responding to the proposed and temporary regulations. After consideration of these comments, the final regulations adopt the provisions of the proposed regulations without substantive change and the corresponding temporary regulations are removed.

Explanation and Summary of Comments

Effective Date of §1.1502–47

The IRS received two comments from the public relating to the effective date of Prop. Reg. §1.1502–47 and Temp. Reg. §1.1502–47T. The proposed and temporary regulations are effective for taxable years for which the due date (without extensions) for filing returns is after April 25, 2006, (their date of publication). Several commentators noted that the preamble to the temporary regulations indicated that the purpose of the separation condition was largely eliminated in 1984 after Congress repealed the three phase system of life insurance company taxation, and it became even less relevant after Congress suspended taxation on distributions from policyholders surplus accounts made during 2005 and 2006. On that basis, these commentators requested that the effective date of the final regulations be applicable retroactively for all open tax years. While making this request, however, the commentators recognized that retroactive application of the regulations would present serious administrative concerns. The IRS and Treasury Department agree with the commentators that retroactive application of the final regulations raises significant questions of administrability. Therefore, in the interest of sound tax administration, the IRS and Treasury Department decline to adopt this suggestion.

Alternatively, the commentators requested that these final regulations be applicable for returns due after the effective date of the temporary regulations. We agree with this suggestion. Accordingly, the temporary regulations are applicable to returns due (without extensions) after April 25, 2006, and on or before the effective date of these final regulations. These final regulations are applicable to returns due (without extensions) after their effective date.

Comments on Prop. Reg. §1.1502–76 and Temp. Reg. §1.1502–76T

One commentator raised several concerns with the proposal to remove Old §1.1502–76(a)(2). First, the commentator reads both the language of section 843 and the legislative history of the amendment to section 843 as demonstrating congressional intent to create a choice, when an insurance company joins a fiscal-year consolidated group, of whether the group remains on the fiscal year (requiring the joining insurance member to adopt the fiscal year) or adopts a calendar year tax year. Amended section 843 provides that (under regulations) an insurance company joining in the filing of a consolidated return "may adopt" the taxable year of the common parent corporation. The legislative history of amended section 843 acknowledges that "[s]ome life companies may not want to adopt a [fiscal] year. . . ." S. Rep. No. 94–938, at 455–56 (1976).

The IRS and Treasury Department do not agree with the commentator's interpretation of the statute or the legislative history. The election discussed in the legislative history is the election under section 1504(c) allowing a life company to join in the consolidated return of a nonlife group. The legislative history notes that "[i]f this election is not made, existing law will continue to apply." The legislative history goes on to state:

> It is understood that although generally companies will probably desire to file consolidated returns with the life or other mutual insurance companies, some may choose to continue to file separate returns under existing law. Where this occurs, it is likely to arise from the fact that the parent corporation (whose year the other members joining in the filing of the consolidated return must follow) uses a fiscal year as its taxable year. Some life companies may not want to adopt a taxable year other than a calendar year since filings with State insurance commissioners are required by these life companies on a calendar year basis.

S. Rep. No. 94–938, at 455–56 (1976).

Rather than suggesting that the group has an election to change its taxable year when a newly-joining life company does not desire to adopt the group's fiscal year, the legislative history suggests that Congress expected, in such cases, that no section 1504(c) election would be made and the life company would continue filing separately. Further, the legislative history is clear that Congress amended section 843 in order to accommodate the consolidated return rules relating to taxable years of members of consolidated groups, not to modify or override them.

The sole purpose of Old §1.1502–76(a)(2) was to conform the consolidated rules to section 843. Once section 843 was amended, not only was the purpose of Old §1.1502–76(a)(2) eliminated, but Old §1.1502–76(a)(2) was no longer operative because it only applies to groups with "an includible insurance company required by section 843 to file its return on the basis of

a calendar year . . . ." For these reasons, the IRS and Treasury Department decline to create a regulatory election allowing fiscal-year consolidated groups to switch to a calendar year upon including an insurance company in its consolidated group.

Another comment noted that the legislative history of the amendment to section 843 contemplates that the Secretary will write regulations that require insurance companies adopting the fiscal year of a consolidated group to maintain adequate records reconciling all of the items on its fiscal year tax return with the corresponding items on its calendar year statements filed with State insurance commissioners. Since the amendment to section 843, the input received by the IRS and Treasury Department from taxpayers has not suggested a need for guidance in this area. However, the IRS and Treasury Department welcome comments on this topic.

The final comment suggested that a rule be added allowing an insurance company that joins a fiscal-year consolidated group and leaves the group before the end of the group's tax year to maintain its calendar year. The comment observed that, without such a rule, §1.1502–76T(a) and section 843 create unnecessary work for such an insurance company because upon joining the group, the insurance company would be required to adopt the common parent's fiscal year under §1.1502–76T(a)(1) and upon leaving the group, the insurance company would have to readopt a calendar year under section 843.

The IRS and Treasury Department decline to adopt this suggestion because they believe that the number of taxpayers affected by such a scenario would be too minimal to justify the creation of a special rule.

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. Pursuant to 5 U.S.C. 553(d)(3) it has been determined that a delayed effective date is unnecessary because this rule finalizes currently effective temporary rules regarding including life insurance companies in a life-nonlife consolidated return. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily affect affiliated groups of corporations with one or more life insurance company members, which tend to be larger businesses. Moreover, the number of taxpayers affected is minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed 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 author of these regulations is Marcie Barese, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for §§1.1502–47T and 1.1502–76T to read, in part, as follows:

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

Section 1.1502–47 also issued under 26 U.S.C. 1502, 1503(c) and 1504(c). * * *

Par. 2. Section 1.1502–47 is amended by revising paragraphs (b)(2) and (d)(12)(v).

The revisions read as follows:

§1.1502–47 Consolidated returns by life-nonlife groups.

* * * * *

(b) * * *

(2) *Tacking rule effective dates*. (i) *In general*. Paragraph (d)(12)(v) of this section applies to any original consolidated Federal income tax return due (without extensions) after July 20, 2007.

(ii) *Prior law*. For original consolidated Federal income tax returns due (without extensions) after April 25, 2006, and on or before July 20, 2007, see §1.1502–47T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before April 25, 2006, see §1.1502–47 as contained in 26 CFR part 1 in effect on April 1, 2006.

* * * * *

(d) * * *

(12) * * *

(v) *Tacking rule*. The period during which an old corporation is in existence and a member of the group engaged in active business is included in (or tacks onto) the period for the new corporation if the following four conditions listed in this paragraph (d)(12)(v) are met. For purposes of this paragraph (d)(12)(v), a new corporation is a corporation (whether or not newly organized) during the period its eligibility depends upon the tacking rule. The four conditions are as follows—

(A) The first condition is that, at any time, 80 percent or more of the new corporation's assets it acquired (other than in the ordinary course of its trade or business) were acquired from the old corporation in one or more transactions described in section 351(a) or 381(a). This asset test is applied by using the fair market values of assets on the date they were acquired and without regard to liabilities. Assets acquired in the ordinary course of business will be excluded from total assets only if they were acquired after the new corporation became a member of the group (determined without section 1504(b)(2)). In addition, assets that the old corporation acquired from outside the group in transactions not conducted in the ordinary course of its trade or business are not included in the 80 percent (but are included in total assets) if the old corporation acquired those assets within five calendar years before the date of their transfer to the new corporation.

(B) The second condition is that at the end of the taxable year during which the first condition is first met, the old corporation and the new corporation must both have the same tax character. For purposes of this paragraph (d)(12), a corporation's tax character is the section under which it would be taxed (*i.e.*, sections 11, 802,

821, or 831) if it filed a separate return. If the old corporation is not in existence (or adopts a plan of complete liquidation) at the end of that taxable year, this paragraph (d)(12)(v)(B) will apply to the old corporation's taxable year immediately preceding the beginning of the taxable year during which the first condition is first met.

(C) The third condition is that, at the end of the taxable year during which the first condition is first met, the new corporation does not undergo a disproportionate asset acquisition under paragraph (d)(12)(viii) of this section.

(D) The fourth condition is that, if there is more than one old corporation, the first two conditions apply to all of the corporations. Thus, the second condition (tax character) must be met by all of the old corporations transferring assets taken into account in meeting the test in paragraph (d)(12)(v)(A) of this section.

* * * * *

§1.1502–47T [Removed]

Par. 3. Section 1.1502–47T is removed.

Par. 4. Section 1.1502–76 is amended by revising paragraphs (a), (b)(2)(ii)(D), and (d).

The revisions read as follows:

§1.1502–76 Taxable year of members of group.

(a) *Taxable year of members of group*. The consolidated return of a group must be filed on the basis of the common parent's taxable year, and each subsidiary must adopt the common parent's annual accounting period for the first consolidated return year for which the subsidiary's income is includible in the consolidated return. If any member is on a 52-53-week taxable year, the rule of the preceding sentence shall, with the advance consent of the Commissioner, be deemed satisfied if the taxable years of all members of the group end within the same 7-day period. Any request for such consent shall be filed with the Commissioner of Internal Revenue, Washington, DC 20224, not later than the 30th day before the due date (not including extensions of time) for the filing of the consolidated return.

(b) * * *

(2) * * *

(ii) * * *

(D) *Election*—(*1*) *Statement*. The election to ratably allocate items under this paragraph (b)(2)(ii) must be made in a separate statement entitled, "THIS IS AN ELECTION UNDER §1.1502–76(b)(2)(ii) TO RATABLY ALLOCATE THE YEAR'S ITEMS OF [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF THE MEMBER]." The election must be filed by including a statement on or with the returns including the items for the years ending and beginning with S's change in status. If two or more members of the same consolidated group, as a consequence of the same plan or arrangement, cease to be members of that group and remain affiliated as members of another consolidated group, an election under this paragraph (b)(2)(ii)(D)(*1*) may be made only if it is made by each such member. Each statement must also indicate that an agreement, as described in paragraph (b)(2)(ii)(D)(*2*) of this section, has been entered into. Each party signing the agreement must retain either the original or a copy of the agreement as part of its records. See §1.6001–1(e).

(*2*) *Agreement*. For each election under this paragraph (b)(2)(ii), the member and the common parent of each affected group must sign and date an agreement. The agreement must—

(*i*) Identify the extraordinary items, their amounts, and the separate or consolidated returns in which they are included;

(*ii*) Identify the aggregate amount to be ratably allocated, and the portion of the amount included in the separate and consolidated returns; and

(*iii*) Include the name and employer identification number of the common parent (if any) of each group that must take the items into account.

* * * * *

(d) *Effective/applicability date*—(1) *Taxable years of members of group effective date*. (i) *In general*. Paragraph (a) of this section applies to any original consolidated Federal income tax return due (without extensions) after July 20, 2007.

(ii) *Prior law*. For original consolidated Federal income tax returns due (without extensions) after April 25, 2006, and on or before July 20, 2007, see §1.1502–76T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before April 25, 2006, see §1.1502–76 as contained in 26 CFR part 1 in effect on April 1, 2006.

(2) *Election to ratably allocate items effective date*. (i) *In general*. Paragraph (b)(2)(ii)(D) of this section applies to any original consolidated Federal income tax return due (without extensions) after July 20, 2007.

(ii) *Prior law*. For original consolidated Federal income tax returns due (without extensions) after May 30, 2006, and on or before July 20, 2007, see §1.1502–76T as contained in 26 CFR part 1 in effect on April 1, 2007. For original consolidated Federal income tax returns due (without extensions) on or before May 30, 2006, see §1.1502–76 as contained in 26 CFR part 1 in effect on April 1, 2006.

§1.1502–76T [Removed]

Par. 5. Section 1.1502–76T is removed.

Par. 6. For each entry in the "Location" column of the following table, remove the language in the "Remove" column and add the language in the "Add" column in its place:

Location	Remove	Add
§1.1502–35(c)(4)(ii)(B)	§1.1502–76T(b)(2)(ii)(D)	§1.1502–76(b)(2)(ii)(D)
§1.1502–76(b)(2)(ii)(A)(*2*)	paragraph (b)(2)(ii)(D) of §1.1502–76T	paragraph (b)(2)(ii)(D) of this section

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

Approved July 16, 2007.

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

(Filed by the Office of the Federal Register on July 19, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 20, 2007, 72 F.R. 39734)

Section 3402.—Income Tax Collected at Source

26 CFR 31.3402(f)(2)–1: Withholding exemption certificates.

T.D. 9337

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 31

Withholding Exemptions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations providing guidance under section 3402(f) of the Internal Revenue Code (Code) for employers and employees relating to the Form W–4, "*Employee's Withholding Allowance Certificate*." The regulations provide rules for income tax withholding when the IRS notifies the employer and the employee of the maximum number of withholding exemptions permitted. The regulations also provide rules for the use of substitute forms and preserve the IRS's ability to require the submission of certain copies of withholding exemption certificates. The regulations primarily affect taxpayers who are employers and employees.

DATES: *Effective Date:* These regulations are effective July 13, 2007.

Applicability Date: Except as provided in section 31.3402(f)(2)–1(g)(5), section 31.3402(f)(2)–1(g) applies on April 14, 2005. Section 31.3402(f)(2)–1(g)(2)(iii)(A), (B), and (C) and section 31.3402(f)(2)–1(g)(2)(ix) apply on October 11, 2007, except taxpayers may rely on such paragraphs for notices issued prior to such date. Section 31.3402(f)(5)–1(a)(1) applies on April 14, 2005. Section 31.3402(f)(5)–1(a)(2) applies October 11, 2007.

FOR FURTHER INFORMATION CONTACT: Ilya Enkishev, (202) 622–0047 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations do not impose any new information collection. The Office of Management and Budget (OMB) previously approved the information collection requirements concerning Form W–4 contained in the regulations under section 6001 (§31.6001–5; OMB Control No. 1545–0798) and in the regulations under section 3402 (§31.3402(f)(2)–1; OMB Control No. 1545–0010) under the provisions of the Paperwork Reduction Act, 44 U.S.C. 3501 *et seq.* Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Under section 3402(f)(2)(A) of the Internal Revenue Code, every employee is required to furnish his or her employer with a signed withholding exemption certificate on or before commencing employment. The regulations prescribe the form of the certificate as the Form W–4. The maximum number of withholding exemptions to which an employee is entitled depends upon the employee's marital status, the employee's filing status, the number of the employee's dependents, the number of exemptions claimed by the employee's spouse (if any) on a Form W–4, and the amount of the employee's estimated itemized deductions, tax credits, and certain other deductions from income.

For many years, the regulations under section 3402(f) required employers to submit to the IRS a copy of each Form W–4 on which an employee claimed more than a certain number of withholding exemptions. Employers had to also submit a copy of each Form W–4 on which the employee claimed a complete exemption from withholding for the taxable year if the employer reasonably expected, when the Form W–4 was received, that the employee's wages from that employer would usually be $200 or more per week. The regulations also provided that the IRS could notify an employer that a named employee was not entitled to claim a complete exemption from withholding and was not entitled to claim more withholding exemptions than the number specified by the IRS in the notice. The IRS issued this notice (often called a "lock-in letter") if the IRS found that the withholding exemption certificate contained a materially incorrect statement or if the IRS found, after written request to the employee for verification of the statements on the certificate, that the IRS lacked sufficient information to determine if the certificate was correct. In these cases, the employer was required to withhold tax based on the number of withholding exemptions specified in the notice from the IRS unless otherwise notified by the IRS.

On April 14, 2005, the Department of Treasury published temporary regulations (T.D. 9196, 2005–1 C.B. 1000) in the **Federal Register** (70 FR 19694) under section 3402(f) modifying the rules relating to the submission of Forms W–4 and relating to the IRS' notification of the number of withholding exemptions permitted. The Department of Treasury also published a notice of proposed rulemaking (REG–162813–04, 2005–1 C.B. 1010) cross-referencing the temporary regulations in the **Federal Register** on the same day.

Effective when published, the temporary regulations changed the procedures for submitting copies of Forms W–4 to the IRS. Specifically, under the temporary regulations employers were no longer routinely required to submit a copy of any Form W–4 on which an employee claimed more than 10 withholding exemptions. In addition, employers were no longer routinely required to submit a copy of any Form W–4 on which an employee claimed complete exemption from withholding for the taxable year if the employer reasonably expected, when the Form W–4 was received, that the employee's wages from that employer would usually be $200 or more per week. Rather, the temporary regulations provided that employers must submit copies of Forms W–4 only if instructed to do so in published guidance or in a written notice to the employer from the IRS. At this time, the IRS has not issued

any published guidance requiring the submission of Forms W–4 to the IRS.

The temporary regulations authorized the IRS to issue a notice to an employer specifying the maximum withholding exemptions permitted to be claimed by the employee without first obtaining a copy of the withholding exemption certificate from the employer. Under the temporary regulations, the IRS issued this notice to the employer with a copy for the employee. The IRS also sent another copy to the employee at the employee's last known address. The temporary regulations provided that the employer must withhold tax in accordance with the notice as of the date specified in the notice, which was required to be at least 45 calendar days after the date of the notice. If the employee wanted to claim complete exemption from withholding or claim more withholding exemptions than the number specified by the IRS in the notice, the employee must contact the IRS to provide information to support the claim. The previous, and now obsolete, regulations permitted the employee to send this information to the employer to forward to the IRS. To reduce burdens on employers and to facilitate efficient responses to the employee, the temporary regulations required the employee to contact the IRS directly.

Finally, the temporary regulations also permitted employers to give their employees a substitute withholding exemption certificate, if the employers also gave them the worksheets contained in the Form W–4 in effect at that time. The temporary regulations also authorized employers to refuse to accept a substitute form developed by an employee.

The proposed regulations were identical to the temporary regulations described in the Preamble. The publication of the proposed and temporary regulations followed a comprehensive review of withholding compliance, which found that withholding noncompliance remained a problem with some employees. In connection with the publication of the proposed and temporary regulations, the IRS developed a process to use information already reported on Forms W–2, *Wage and Tax Statements*, to more effectively identify and address employees with withholding compliance problems.

A public hearing on the proposed regulations was held on July 26, 2005. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the Department of Treasury adopts the proposed regulations, as modified herein, as final regulations, and removes the corresponding temporary regulations.

Summary of Comments and Explanation of Provisions

The publication of this Treasury decision follows the implementation of the IRS's new process for using information already reported on Forms W–2 to more effectively identify employees with withholding compliance problems. The modifications to the proposed regulations that are included in these final regulations reflect both consideration of the comments submitted by taxpayers and changes needed following the implementation of the new process.

The comments received were generally favorable to the changes proposed by the proposed regulations and implemented by the temporary regulations. Commentators observed that the regulations reduced burdens on employers by eliminating the requirement that employers submit questionable Forms W–4 to the IRS and the requirement that employers transmit communications from the employee to the IRS. One commentator recommended that, as an alternative to the withholding compliance program, the problem of underwithholding should be addressed by increasing the employee's estimated tax penalty if insufficient taxes are withheld and otherwise paid by the employee for the year. While tax penalties do deter some employees from submitting Forms W–4 claiming excessive withholding exemptions, the IRS has concluded that the withholding compliance program implemented under the temporary regulations is a more efficient and effective manner of deterring serious underwithholding.

Submission of Withholding Exemption Certificates

Under the temporary regulations, employers were no longer routinely required to submit copies of Forms W–4 that met the previously established criteria, often referred to as "Questionable W–4s". Rather, the temporary regulations provided that an employer must submit a copy of any currently effective Form W–4 only if directed to do so in a written notice to the employer from the IRS or if directed to do so under any published guidance.

Some commentators observed that requiring employers to submit questionable Forms W–4 to the IRS may have deterred employees from furnishing a Form W–4 claiming excessive withholding exemptions. Some employers have expressed the concern that eliminating the submission requirement will result in more employees submitting Forms W–4 claiming excessive withholding allowances. While the Department of Treasury and the IRS acknowledge the possible deterrent effect of a requirement to submit certain Forms W–4 to the IRS, they have concluded that the final regulations are a more efficient and effective manner of deterring withholding compliance problems. Accordingly, the final regulations do not require the routine submission of Forms W–4, but permit the IRS to require submission of Forms W–4 under specific criteria either by written notice or by future published guidance. The final regulations do not change an employee's obligations to provide an accurate Form W–4 to an employer and to satisfy his or her tax obligations on a timely basis. Thus, employees may be subject to penalties if they claim excessive withholding exemptions on Forms W–4 or fail to file their tax returns and pay their full tax liabilities on a timely basis.

Some commentators have suggested that if the IRS requires an employer to submit certain Forms W–4 by a written notice or published guidance, the employer should have the ability to provide the requested Forms W–4 by electronic means. The final regulations do not address this comment as the available and appropriate means for submission can be determined by the IRS in specific cases or in the context of any future published guidance requiring the submission of Forms W–4.

Valid and Invalid Withholding Exemption Certificates

In the Preamble to the proposed and temporary regulations, the Department of Treasury and IRS requested comments specifically with regard to the

criteria for identifying a valid withholding exemption certificate contained in §31.3402(f)(5)–1(a)(1) of the Employment Tax Regulations. While a few comments were received, they were not likely to provide significant assistance to employers or the IRS in identifying potentially invalid withholding exemption certificates. Accordingly, these final regulations do not change the existing rules on when to treat a withholding exemption certificate as invalid.

Effect of Notice Specifying the Maximum Withholding Exemptions Permitted

The final regulations, like the temporary regulations, authorize the IRS to issue a notice to an employer specifying the maximum number of withholding exemptions permitted for a specific employee. The IRS may issue such a notice after it determines an employee is not entitled to claim exemption from withholding or more than a specified number of withholding exemptions based on IRS records, without first obtaining a copy of the withholding exemption certificate from the employer. Alternatively, the IRS may issue such notice after it reviews a particular withholding exemption certificate and determines that the withholding exemption certificate contains a materially incorrect statement or determines, after a request to the employee for verification of the statements on the certificate, that the IRS lacks sufficient information to determine if the certificate is correct.

The IRS will send the notice both to the employer (with a copy for the employee) and to the employee directly. The final regulations provide a period during which the employee can address the pending withholding adjustment by contacting the IRS. The final regulations provide that the earliest the notice may be effective is 45 calendar days after the date of the notice. The notice may specify a later effective date.

One commentator expressed a concern held by some employers regarding the need to "warehouse" the notice for the 45-day period and suggested that instead the IRS either (1) send the notice first to the employee before involving the employer or (2) not require the employer to implement the notice until a subsequent "final" notice is sent to the employer. The final regulations retain the approach of the proposed and temporary regulations, including a delay period, to balance the need to ensure that the employee receives the notice and to provide time for the employee to discuss the appropriate withholding with the IRS. Consistent with the intent to ensure that the employee receives the notice, the final regulations also provide that if the IRS is unable to determine a last known address for the employee, the IRS will use other available information as appropriate to provide the notice to the employee.

The final regulations also clarify that the notice to an employer specifying the maximum withholding exemptions permitted for a specific employee will also specify the marital status for purposes of calculating the required withholding under the notice. Accordingly, the employer must use the maximum number of withholding exemptions permitted and marital status specified in the notice for calculating income tax withholding, unless a new withholding exemption certificate is submitted by the employee that must be honored under these final regulations. Specifically, if, at any time, the employee furnishes a withholding exemption certificate that claims a marital status, a number of withholding exemptions, and any additional withholding that results in more withholding than would result from applying the marital status and number of withholding exemptions permitted in the notice, the employer must withhold tax based on that certificate. The IRS may also issue a modification notice to the employer that the employer must implement as of the date in the notice. This notice may change the marital status and/or the maximum number of withholding exemptions permitted.

Although this issue was not raised in the comments, in the course of conducting the withholding compliance program, the IRS has received questions from taxpayers asking about the implications of receiving a notice specifying the maximum number of withholding exemptions permitted and marital status when possible exclusions from withholding apply. Receipt of an IRS notice does not impose a requirement to withhold income taxes where one does not already exist. For example, under section 3401(a)(8)(A)(i) of the Code, employers do not have to withhold income taxes from payments made to employees who are United States citizens working in foreign countries if the employer reasonably believes that the payments are excluded from taxation under section 911 of the Code. Issuance of an IRS notice to an employer properly relying on this exclusion does not impose a withholding requirement on amounts covered by the exclusion. However, if withholding is required, such as on wages paid in excess of the amount excludable under section 911, or if the exclusion ceases to apply to amounts paid by the employer to the employee, the employer must withhold on the basis of the marital status and maximum number of withholding exemptions set forth in the IRS notice. An example has been added to the regulations to illustrate this point.

Employer Furnishing IRS Notice to Employee

The final regulations provide that, if the employee is still employed by the employer, the employer must furnish the notice of maximum number of withholding exemptions permitted to the employee within 10 business days of receipt. Commentators questioned whether they may furnish the employee's copy electronically. The final regulations clarify that the employer may furnish the copy of the IRS notice to the employee within the 10 required business days using any reasonable business practice. For example, an employer might provide the employee with a paper copy of the notice or might transmit a copy using a secure and reliable electronic means of communication.

Terminated, Rehired, and Seasonal Employees

The proposed and temporary regulations provided that the employer is not required to furnish the IRS employee notice to the employee if the employee is no longer employed by the employer. In such a case, the employer must send a written response to the IRS office designated in the notice indicating that the employee is no longer employed by the employer. Some commentators have expressed concerns over application of the regulations to employees who are not currently performing services, but may resume employment in the future, such as seasonal employees or rehired employees. Specifically, the

comments requested assistance in determining when an employee is "no longer employed," and asked whether an employer is required to retain an IRS notice for future implementation should an employee be rehired or resume performance of services. One commentator recommended that the employer be required to retain the notice no later than the end of the calendar year in which the employee terminates, or one year after termination.

After consideration of these comments, the final regulations modify the proposed regulations to clarify that the determination of whether the employee is employed is made as of the date of the notice, and is based on all the facts and circumstances, including whether the employer has treated the employment relationship as terminated for other purposes. The final regulations also specifically state that an employee who is not currently performing services is nevertheless employed for purposes of this rule if on the date of the notice (a) the employer pays wages subject to income tax withholding to the employee with respect to prior employment on or after the date specified in the notice, (b) the employer reasonably expects the employee to resume the performance of services for the employer within twelve months of the date of the notice, or (c) the employee is on a *bona fide* leave of absence if the period of such leave does not exceed twelve months or if the individual retains a right to reemployment with the employer by contract or under an applicable statute, such as the Family Medical Leave Act.

If the employer must furnish the notice under these final regulations, the employer must withhold based on the notice as of the date specified in the notice unless one of the regulatory exceptions applies. Specifically, the employer must withhold based on the notice unless (a) the employer receives a modification notice, (b) the employee has provided or provides a new Form W–4 that results in more withholding than would result based on the notice, (c) the employer is required to furnish the notice only because the employer reasonably expects the employee to resume the performance of services within twelve months of the date of the notice but the employee does not resume the performance of services until after such time, or (d) the employment relationship is terminated for more than twelve months. The regulations include examples to illustrate these requirements.

Notices to Other Employers

One commentator questioned whether an employer has any obligation with respect to an IRS notice issued to another employer, such as a related entity or an employer using the same entity as its "payroll agent," with respect to the same employee. The commentator also proposed that an employer be able to rely on any subsequent notices provided by the IRS with regard to an employee (for example, modifying the maximum number of withholding exemptions permitted) while the employee was employed by another employer.

The final regulations do not adopt these proposals. Other than when an employer qualifies as a "successor employer" within the meaning of section 3121(a)(1) of the Code and §31.3121(a)(1)–1(b) of the Employment Tax Regulations and uses the alternate procedure described in Rev. Proc. 2004–53, 2004–2 C.B. 320, an employer's liability for withholding under section 3402 is determined separately with regard to that employer. Rev. Proc. 2004–53 provides that, under the alternative procedure, the predecessor employer must transfer to the successor employer all current Forms W–4 that were provided to the predecessor by the acquired employees and any written notices received from the IRS under §31.3402(f)(2)–1(g). The revenue procedure also provides that the successor employer must withhold amounts from the employees on the basis of the maximum number of withholding exemptions specified in any written notices from the IRS under §31.3402(f)(2)–1(g). Accordingly, the provision of an IRS notice or a subsequent IRS notice to another employer is not relevant in determining the employer's obligation to withhold income taxes under these final regulations.

Substitute Forms W–4

Some commentators have suggested that employers must refuse to accept substitute Forms W–4 developed by employees. After consideration of this comment, the final regulations provide that employers may not accept a substitute form developed by an employee, and the employee submitting such form will be treated as failing to furnish a withholding exemption certificate.

Effective Date

The final regulations are generally effective on April 14, 2005, the date the temporary regulations were published in the Federal Register. However, the new provisions in the final regulations that (a) specify when an employee who is not currently performing services is employed for purposes of the requirements to furnish the employee notice and withhold based on the notice, (b) require the employer to withhold based on the notice if a terminated employment relationship is resumed within 12 months, and (c) require employers to refuse to accept substitute withholding exemption certificates developed by employees apply on October 11, 2007. However, taxpayers may rely on such provisions for notices issued prior to such date.

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 the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 31 is amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT THE SOURCE.

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

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

Par. 2. Section 31.3402(f)(2)–1 is amended by revising paragraph (g) to read as follows:

§31.3402(f)(2)–1 Withholding exemption certificates.

* * * * *

(g) *Submission of certain withholding exemption certificates and notice of the maximum number of withholding exemptions permitted* — (1) *Submission of certain withholding exemption certificates.* — (i) *In general.* An employer must submit to the Internal Revenue Service (IRS) a copy of any currently effective withholding exemption certificate as directed in a written notice to the employer from the IRS or as directed in published guidance.

(A) *Notice to submit withholding exemption certificates.* A notice to the employer to submit withholding exemption certificates may relate either to one or more named employees, to one or more reasonably segregable units of the employer, or to withholding exemption certificates under certain specified criteria. The notice will designate the IRS office where the copies of the withholding exemption certificates must be submitted. Alternatively, upon notice from the IRS, the employer must make available for inspection by an IRS employee withholding exemption certificates received from one or more named employees, from one or more reasonably segregable units of the employer, or from employees who have furnished withholding exemption certificates under certain specified criteria.

(B) *Published guidance.* Employers may also be required to submit copies of withholding exemption certificates under certain specified criteria when directed to do so by the IRS in published guidance. For purposes of the preceding sentence, the term published guidance means a revenue procedure or notice published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(ii) *Withholding after submission of withholding exemption certificate.* After a copy of a withholding exemption certificate has been submitted to the IRS under this paragraph (g)(1), the employer must withhold tax on the basis of the withholding exemption certificate, if the withholding exemption certificate meets the requirements of §31.3402(f)(5)–1. However, the employer may not withhold on the basis of the withholding exemption certificate if the certificate must be disregarded based on a notice of the maximum number of withholding exemptions permitted under the provisions of paragraph (g)(2) of this section.

(2) *Notice of the maximum number of withholding exemptions permitted* — (i) *Notice to employer.* The IRS may notify the employer in writing that the employee is not entitled to claim a complete exemption from withholding or more than the maximum number of withholding exemptions specified by the IRS in the written notice. The notice will also specify the applicable marital status for purposes of calculating the required amount of withholding. The notice will specify the IRS office to be contacted for further information. The notice of maximum number of withholding exemptions permitted may be issued if—

(A) The IRS determines that a copy of a withholding exemption certificate submitted under paragraph (g)(1) of this section or otherwise provided to the IRS contains a materially incorrect statement or determines, after a request to the employee for verification of the statements on the certificate, that the IRS lacks sufficient information to determine if the certificate is correct.

(B) The IRS otherwise determines that the employee is not entitled to claim a complete exemption from withholding and is not entitled to claim more than a specified number of withholding exemptions.

(ii) *Notice to employee.* If the IRS provides a notice to the employer under this paragraph (g)(2), the IRS will also provide the employer with a similar notice for the employee (employee notice) that identifies the maximum number of withholding exemptions permitted and specifies the marital status to be used for calculating the required amount of withholding. The employee notice will also indicate the process by which the employee can provide additional information to the IRS for purposes of determining the appropriate number of withholding exemptions and/or modifying the specified marital status. The IRS will also mail a similar notice to the employee's last known address. For further guidance regarding the definition of last known address, see §301.6212–2 of this chapter. If the IRS is unable to determine a last known address for the employee, the IRS will use other available information as appropriate to mail the notice to the employee.

(iii) *Requirement to furnish.* If the employee is employed by the employer as of the date of the notice, the employer must furnish the employee notice to the employee within 10 business days of receipt. The employer may follow any reasonable business practice to furnish the copy of the notice to the employee. For purposes of this paragraph (g)(2)(iii), the determination of whether an employee is employed as of the date of the notice is based on all the facts and circumstances, including whether the employer has treated the employment relationship as terminated for other purposes. An employee that is not performing services for the employer as of the date of the notice is employed by the employer as of the date of the notice for purposes of this paragraph (g)(2)(iii) if—

(A) The employer pays wages with respect to prior employment to the employee subject to income tax withholding on or after the date specified in the notice;

(B) The employer reasonably expects the employee to resume the performance of services for the employer within twelve months of the date of the notice; or

(C) The employee is on a *bona fide* leave of absence if the period of such leave does not exceed twelve months or the employee retains a right to reemployment with the employer under an applicable statute or by contract.

(iv) *Requirement to notify the IRS.* If the employer is not required to furnish the notice to the employee under paragraph (g)(2)(iii) of this section, the employer must send a written response to the IRS office designated in the notice indicating that the employee is not employed by the employer.

(v) *Requirement to withhold based on the notice.* If the employer is required to furnish the employee notice to the em-

ployee under paragraph (g)(2)(iii) of this section, then the employer must withhold tax on the basis of the maximum number of withholding exemptions and the marital status specified in the notice for any wages paid after the date specified in the notice, except as provided in paragraphs (g)(2)(vi), (vii), (viii), (ix), and (x) of this section. The employer must withhold tax in accordance with the notice as of the date specified in the notice, which shall be no earlier than 45 calendar days after the date of the notice.

(vi) *Employment resumes after twelve months*. If the employer is required to furnish the employee notice to the employee only pursuant to paragraph (g)(2)(iii)(B) of this section and the employee resumes the performance of services for the employer more than 12 months after the date of the notice, then the employer is not required to withhold based on the notice.

(vii) *Requirement to withhold based on an existing Form W–4*. If a withholding exemption certificate is in effect with respect to the employee before the employer receives a notice of the maximum number of withholding exemptions permitted under this paragraph (g)(2) of this section, the employer must continue to withhold tax in accordance with the existing withholding exemption certificate, rather than on the basis of the notice, if the existing withholding exemption certificate does not claim complete exemption from withholding and claims a marital status, a number of withholding exemptions, and any additional withholding that results in more withholding than would result from applying the marital status and number of withholding exemptions specified in the notice.

(viii) *Modification notice*. After issuing the notice specifying the maximum number of withholding exemptions permitted and the marital status, the IRS may issue a subsequent notice that modifies the original notice (modification notice). The modification notice may change the marital status and/or the number of withholding exemptions permitted. The employer must withhold based on the modification notice as of the date specified in the modification notice.

(ix) *Requirement to withhold after termination of employment*. If the employee is employed as of the date of the notice under paragraph (g)(2)(iii) of this section, but the employer or employee terminates the employment relationship after the date of the notice, the employer must continue to withhold based on the maximum number of withholding exemptions and the marital status specified in the notice or a modification notice if any wages subject to income tax withholding are paid with respect to the prior employment after such date. Furthermore, the employer must withhold based on the notice or modification notice if the employee resumes an employment relationship with the employer within 12 months after the termination of the employment relationship. Whether the employment relationship is terminated is based on all the facts and circumstances.

(x) *Requirement to withhold based on new Form W–4*. The employee may furnish a new withholding exemption certificate after the employer receives a notice or modification notice from the IRS of the maximum number of withholding exemptions permitted under this paragraph (g)(2).

(A) *Employee requests more withholding*. If the employee furnishes a new withholding exemption certificate after the employer receives the notice or modification notice, the employer must withhold tax on the basis of that new certificate only if the new certificate does not claim complete exemption from withholding and claims a marital status, a number of withholding exemptions, and any additional withholding that results in more withholding than would result under the notice or modification notice.

(B) *Employee requests less withholding*. If the employee furnishes a new withholding exemption certificate after the employer receives the notice or modification notice, the employer must disregard the new certificate and withhold on the basis of the notice or modification notice if the employee claims complete exemption from withholding or claims a marital status, a number of withholding exemptions, and any additional withholding that results in less withholding than would result under the notice or modification notice. If the employee wants to put a new certificate into effect that results in less withholding than that required under the notice or modification notice, the employee must contact the IRS. The employer must withhold on the basis of the notice or modification notice unless the IRS subsequently notifies the employer to withhold based on the new certificate.

(3) *Definition of employer*. For purposes of this paragraph (g), the term employer includes any person authorized by the employer to receive withholding exemption certificates, to make withholding computations, or to make payroll distributions.

(4) *Examples*. The following examples illustrate the rules of this section.

Example 1. Employer U receives a notice from the IRS that identifies the maximum number of withholding exemptions permitted and specifies the marital status for Employee A. Employee A is not currently performing any services for Employer U. However, Employer U is continuing to make certain wage payments to Employee A. Employer U must furnish the employee notice to Employee A within 10 business days of receipt and must withhold based on the notice on any wages paid to Employee A on or after the date specified in the notice.

Example 2. Employer V receives a notice in October of Year 1 from the IRS that identifies the maximum number of withholding exemptions permitted and specifies the marital status for Employee B. Employee B has not performed services for Employer V since August of Year 1. However, since Employee B has performed services for Employer V for several years on a seasonal basis, Employer V reasonably expects Employee B to resume the performance of services for Employer V in June of Year 2, a date that is within 12 months of the date of the notice. Employer V is required to furnish the notice to Employee B within 10 business of receipt. Employee B does not resume the performance of services until June of Year 3. Employer V is not required to withhold based on the notice.

Example 3. Employer W receives a notice from the IRS that identifies the maximum number of withholding exemptions permitted and specifies the marital status for Employee C. Employee C began a 4-month unpaid maternity leave of absence three weeks before Employer W received the notice. Employer W must furnish the employee notice to Employee C within 10 business days of receipt. When Employee C resumes performing services when her maternity leave ends, Employer W must withhold based on the notice.

Example 4. Employer X receives a notice from the IRS in Year 1 that identifies the maximum number of withholding exemptions permitted and specifies the marital status for Employee D. Employer X must furnish the employee notice to Employee D within 10 business days of receipt and withhold based on the notice. In Year 2, Employee D terminates the employment relationship. Employee D applies for a different position with Employer X and resumes employment 10 months after having left her previous position with Employer X. Since Employer X rehired Employee D within 12 months after the termination of employment, Employer X must withhold based on the notice.

Example 5. Employer Y receives a notice from the IRS that identifies the maximum number of withholding exemptions permitted and specifies the marital status for Employee E. Employer Y must furnish

the employee notice to Employee E within 10 business days of receipt. After receipt of this notice, Employee E contacts the IRS and establishes that he is entitled to claim a higher number of withholding exemptions. Employer Y receives a modification notice from the IRS that changes the maximum number of withholding exemptions permitted for Employee E. Employer Y must withhold tax based on the modification notice as of the date specified in such notice.

Example 6. Employer Z pays remuneration to Employee F, a United States citizen, for services performed in Country M. Employer Z receives a notice from the IRS in Year 1 that identifies the maximum number of withholding exemptions permitted and specifies the marital status for Employee F. Employer Z must furnish the employee notice to Employee F within 10 business days of receipt. Employer Z reasonably believes all the remuneration paid to Employee F in Year 1 is excluded from Employee F's gross income under section 911 of the Internal Revenue Code. Since section 3401(a)(8)(B) excludes such remuneration from wages for income tax withholding purposes, Employer X does not have to withhold on such remuneration, notwithstanding the maximum number of exemptions permitted and marital status specified in the notice. In Year 2, Employee F returns to the United States to perform services. Employer Z does not reasonably believe any part of Employee F's remuneration paid in Year 2 is excluded from Employee F's gross income under section 911. Rather, Employer Z reasonably believes that remuneration paid to Employee F in Year 2 is subject to income tax withholding. Employer Z must withhold on the remuneration paid to Employee F based on the notice.

(5) *Effective/applicability date*. Except as provided in this paragraph (g)(5), paragraph (g) applies on April 14, 2005. Paragraphs (g)(2)(iii)(A), (B), and (C) and paragraph (g)(2)(ix) apply on October 11, 2007, except taxpayers may rely on such paragraphs for notices issued prior to such date.

§31.3402(f)(2)–1T [Removed]

Par. 3. Section 31.3402(f)(2)–1T is removed.

Par. 4. Section 31.3402(f)(5)–1 is amended by revising paragraph (a) to read as follows:

§31.3402(f)(5)–1 Form and contents of withholding exemption certificates.

(a)(1) *Form W–4*. Form W–4, "*Employee's Withholding Allowance Certificate*," is the form prescribed for the withholding exemption certificate required to be furnished under section 3402(f)(2). A withholding exemption certificate must be prepared in accordance with the instructions and regulations applicable thereto, and must set forth fully and clearly the data that is called for therein. Blank copies of paper Forms W–4 will be supplied to employers upon request to the Internal Revenue Service (IRS). An employer may also download and print Form W–4 from the IRS Internet site at *www.irs.gov*. In lieu of the prescribed form, employers may prepare and use a form the provisions of which are identical with those of the prescribed form, but only if employers also provide employees with all the tables, instructions, and worksheets contained in the Form W–4 in effect at that time, and only if employers comply with all revenue procedures relating to substitute forms in effect at that time.

(2) Employers are prohibited from accepting a substitute form developed by an employee, and the employee submitting such form will be treated as failing to furnish a withholding exemption certificate. For further guidance regarding the employer's obligations when an employee is treated as failing to furnish a withholding exemption certificate, see §31.3402(f)(2)–1.

(3) *Effective/applicability date*. Paragraph (a)(1) applies on April 14, 2005. Paragraph (a)(2) applies to any substitute withholding exemption certificate furnished to an employer on or after October 11, 2007.

* * * * *

§31.3402(f)(5)–1T [Removed]

Par. 5. Section 31.3402(f)(5)–1T is removed.

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

Approved July 2, 2007.

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

(Filed by the Office of the Federal Register on July 12, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 13, 2007, 72 F.R. 38478)

Section 6012.—Persons Required to Make Returns of Income

26 CFR 1.6012–2: Corporations required to make returns of income.

T.D. 9336

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Return Required by Subchapter T Cooperatives Under Section 6012

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that prescribe the form that cooperatives must use to file their income tax returns. The regulations affect all cooperatives that are currently required to file an income tax return on either Form 1120, "*U.S. Corporation Income Tax Return*," or Form 990–C, "*Farmers' Cooperative Association Income Tax Return*." The new form will help the IRS to properly identify cooperatives and differentiate between cooperatives that must file returns within 2 1/2 months of the end of the taxable year and those that must file within 8 1/2 months of the end of the taxable year.

DATES: *Effective date:* These regulations will be effective July 30, 2007.

Applicability date: These regulations apply to returns for taxable years ending on or after December 31, 2007. In addition, taxpayers may rely on the regulations in filing returns for taxable years ending on or after December 31, 2006, and before December 31, 2007.

FOR FURTHER INFORMATION CONTACT: Matthew P. Howard, (202) 622–4910 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Under existing regulations, all cooperatives to which subchapter T applies

(Subchapter T cooperatives) are required to make income tax returns. Except in the case of farmers' cooperatives, the regulations require that the return be made on Form 1120. In the case of farmers' cooperatives, the regulations require that the return be made on Form 990–C.

Most taxpayers required to make an income tax return on Form 1120 must file their return on or before the 15th day of the third month following the close of the taxpayer's taxable year (2½ month deadline). Some Subchapter T cooperatives that make their returns on Form 1120 are required to file by the 2½ month deadline, but others are not required to file their returns until the 15th day of the ninth month following the close of the taxpayer's taxable year (8½ month deadline). Because the Form 1120 does not distinguish between Subchapter T cooperatives that must file by the 2½ month deadline and those that must file by the 8½ month deadline, the IRS has difficulty determining which filing deadline applies and deciding whether to assert delinquency and failure to pay penalties in the case of returns filed after the 2½ month deadline.

The Proposed Regulations

On July 29, 2005, a notice of proposed rulemaking was published in the **Federal Register** (REG–149436–04, 2005–2 C.B. 454 [70 FR 43811]). The proposed regulations in this notice of proposed rulemaking would require all Subchapter T cooperatives to make their income tax returns on Form 1120–C, "*U.S. Income Tax Return for Cooperative Associations*," or such other form as may be designated by the Commissioner.

One telephone comment was received in response to the notice of proposed rulemaking. The comment suggested that the new form might have a negative effect on consolidated filing. No public hearing was requested or held.

Explanation of Provisions

After consideration of the comment, the proposed regulations are adopted as revised by this Treasury decision. The final regulations retain the requirement that Subchapter T cooperatives file their returns on Form 1120–C. The information that Subchapter T cooperatives will be required to provide on new Form 1120–C will assist taxpayers and the IRS in determining the appropriate filing deadline. Having that information will reduce the burden on taxpayers and will help the IRS avoid asserting penalties in inappropriate cases. Having all Subchapter T cooperatives make their income tax returns on Form 1120–C will also eliminate confusion over which form to file and will promote efficiency in addressing income tax issues common to Subchapter T cooperatives.

The IRS and Treasury Department believe that this requirement will not have a negative effect on consolidated filing. Subchapter T cooperatives may continue to file returns on behalf of consolidated groups by indicating their filing status on Form 1120–C and complying with the regulations under section 1502 of the Internal Revenue Code (Code).

This requirement to use Form 1120–C was proposed to be effective for taxable years ending on or after December 31, 2006. Because the regulations were not finalized before the end of 2006, the final regulations delay the proposed effective date. The final regulations apply beginning with the first taxable year ending on or after December 31, 2007. Cooperatives may rely on the regulations as proposed, however, and file returns on Form 1120–C for taxable years ending on or after December 31, 2006, and before December 31, 2007.

Effect on Other Documents

The following publications are obsoleted as of July 30, 2007.

Announcement 84–26, 1984–11 I.R.B. 42.

Announcement 84–37, 1984–17 I.R.B. 32.

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 the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal author of these regulations is Matthew P. Howard, Office of Associate Chief Counsel (Procedure & Administration).

* * * * *

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 1.6012–2 is amended by revising paragraph (f) to read as follows:

§1.6012–2 Corporations required to make returns of income.

* * * * *

(f) *Subchapter T cooperatives*—(1) *In general*. For taxable years ending on or after December 31, 2007, a cooperative organization described in section 1381 (including a farmers' cooperative exempt from tax under section 521) is required to make a return, whether or not it has taxable income and regardless of the amount of its gross income, on Form 1120–C, "*U.S. Income Tax Return for Cooperative Associations*," or such other form as may be designated by the Commissioner.

(2) *Farmers' cooperatives*. For taxable years ending before December 31, 2007, a farmers' cooperative organization described in section 521(b)(1) (including a farmers' cooperative that is not exempt from tax under section 521) is required to make a return on Form 990–C, "*Farmers' Cooperative Association Income Tax Return*."

(3) *Effective/applicability date*. This paragraph (f) is applicable on or after July 30, 2007.

* * * * *

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

Approved June 27, 2007.

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

(Filed by the Office of the Federal Register on July 27, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 30, 2007, 72 F.R. 41441)

Section 6038.—Information Reporting With Respect to Certain Foreign Corporations and Partnerships

26 CFR 1.6038–2: Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations beginning after December 31, 1962.

T.D. 9338

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Information Returns Required With Respect to Certain Foreign Corporations and Certain Foreign-Owned Domestic Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that provide guidance under sections 6038 and 6038A of the Internal Revenue Code (Code). The final regulations clarify the information required to be furnished regarding certain related party transactions of certain foreign corporations and certain foreign-owned domestic corporations. The final regulations also increase the amount of certain penalties, and make certain other changes, to reflect the statutory changes made by the Taxpayer Relief Act of 1997.

DATES: *Effective Date:* These regulations are effective July 13, 2007.

Applicability Date: For dates of applicability, see §§1.6038–2(m) and 1.6038A–2(h).

FOR FURTHER INFORMATION CONTACT: Kate Y. Hwa (202) 622–3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–2020. Responses to this collection of information are mandatory.

The collection of information is in §1.6038–2(f)(11). This information is required by the IRS pursuant to section 6038 of the Code. The likely recordkeepers are business or other for-profit institutions. The estimated burden is as follows:

Estimated total annual reporting and/or recordkeeping burden: 1250 hours.

Estimated average annual burden per respondent: 15 minutes.

Estimated number of respondents: 5,000.

Estimated annual frequency of responses: once.

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

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

Background

This document contains final amendments to the Income Tax Regulations (26 CFR part 1) under sections 6038 and 6038A of the Code. On June 21, 2006, final and temporary regulations (T.D. 9268, 2006–30 I.R.B. 94) under sections 6038 and 6038A were published in the **Federal Register** (71 FR 35524). On the same day, a notice of proposed rulemaking (REG–109512–05, 2006–30 I.R.B. 100) was published by cross-reference to the temporary regulations in the **Federal Register** (71 FR 35592). The preamble of T.D. 9268 includes background information and an explanation of provisions regarding these regulations.

The IRS received no comments in response to the notice of proposed rulemaking. No requests to speak at a public hearing were received and no hearing was held. Accordingly, the proposed regulations are adopted without change by this Treasury decision and the corresponding temporary regulations are removed or removed and reserved.

The Treasury Department, however, is considering additional information reporting pursuant to section 6038A of the Code regarding section 163(j) to further the administration of the earning stripping rules.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations only affect entities with significant foreign operations and any burden on small entities is minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Kate Y. Hwa, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and

Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6038–2 is amended as follows:

1. Paragraphs (a)(1) and (a)(2) are revised.

2. Paragraphs (f)(11), (f)(12), (k)(1) and (m) are revised.

3. Paragraph (k)(5) is amended by adding *Examples 3* and *4*.

The revisions and additions read as follows:

§1.6038–2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations beginning after December 31, 1962.

(a) * * *

(1) Form 2952, "*Information Return with Respect to Controlled Foreign Corporations*," if such taxable year ends before December 31, 1982;

(2) Form 5471, "*Information Return of U.S. Persons With Respect To Certain Foreign Corporations*," if such taxable year ends on or after December 31, 1983; or

* * * * *

(f) * * *

(11) *Transactions with certain related parties*. (i) A summary showing the total amount of each of the following types of transactions of the corporation, which took place during the annual accounting period, with the person required to file this return, any other corporation or partnership controlled by that person, or any United States person owning at the time of the transaction 10 percent or more in value of any class of stock outstanding of the foreign corporation, or of any corporation controlling that foreign corporation—

(A) Sales and purchases of stock in trade;

(B) Sales and purchases of tangible property other than stock in trade;

(C) Sales and purchases of patents, inventions, models, or designs (whether or not patented), copyrights, trademarks, secret formulas or processes, or any other similar property rights;

(D) Compensation paid and compensation received for the rendition of technical, managerial, engineering, construction, scientific, or like services;

(E) Commissions paid and commissions received;

(F) Rents and royalties paid and rents and royalties received;

(G) Amounts loaned and amounts borrowed (except open accounts resulting from sales and purchases reported under other items listed in this paragraph (f)(11) that arise and are collected in full in the ordinary course of business);

(H) Dividends paid and dividends received;

(I) Interest paid and interest received; and

(J) Premiums paid and premiums received for insurance or reinsurance.

(ii) *Special rule for banks*. For purposes of this paragraph (f)(11), if the United States person is a bank, as defined in section 581, or is controlled within the meaning of section 368(c) by a bank, the term transactions shall not, as to a corporation with respect to which a return is filed, include banking transactions entered into on behalf of customers; in any event, however, deposits in accounts between a foreign corporation, controlled (within the meaning of paragraph (b) of this section) by a United States person, and a person described in this paragraph (f)(11) and withdrawals from such accounts shall be summarized by reporting end-of-month balances.

(12) *Accrued payments and receipts*. For purposes of the required summary under paragraph (f)(11) of this section, a corporation that uses an accrual method of accounting shall use accrued payments and accrued receipts for purposes of computing the total amount of each of the types of transactions listed.

* * * * *

(k) *Failure to furnish information*—(1) *Dollar amount penalty*—(i) *In general*. If any person required to file Form 5471 under section 6038 and this section fails to furnish any information described in paragraphs (f) and (g) of this section within the time prescribed by paragraph (i) of this section, such person shall pay a penalty of $10,000 for each annual accounting period of each foreign corporation with respect to which such failure occurs.

(ii) *Increase in penalty for continued failure after notification*. If a failure described in paragraph (k)(1)(i) of this section continues for more than 90 days after the date on which the Director of Field Operations, Area Director, or Director of Compliance Campus Operations mails notice of such failure to the person required to file Form 5471, such person shall pay a penalty of $10,000, in addition to the penalty imposed by section 6038(b)(1) and paragraph (k)(1)(i) of this section, for each 30-day period (or a fraction of) during which such failure continues after such 90-day period has expired. The additional penalty imposed by section 6038(b)(2) and this paragraph (k)(1)(ii) shall be limited to a maximum of $50,000 for each failure.

* * * * *

(5) * * *

Example 3. A, a US person, owns 100 percent of the stock of FC. On April 15, 2008, A timely filed its 2007 income tax return but did not file Form 5471 with respect to FC's 2007 annual accounting period. On June 1, 2008, the Director of Field Operations mailed a notice to A of A's failure to file Form 5471 for 2007 with respect to FC. On August 1, 2008, A submits a written statement asserting facts for reasonable cause for failure to file the 2007 Form 5471 for FC. Based on A's statement and discussions with A, the Director of Field Operations agrees that A had reasonable cause for failure to file FC's 2007 Form 5471 and determined that it is reasonable for A to file FC's 2007 Form 5471 by September 15, 2008. The time prescribed for furnishing information under paragraph (i) of this section is September 15, 2008, and the 90-day period described under paragraphs (k)(1)(ii) and (k)(2)(iv)(A) of this section begins on that same date. Thus, if A files a completed Form 5471 by September 15, 2008, A is not subject to the penalties under paragraphs (k)(1) and (k)(2) of this section. If A does not file a completed Form 5471 by December 14, 2008, in addition to the penalties under paragraphs (k)(1) and (k)(2) of this section, A will also be subject to the penalties for continued failure under paragraphs (k)(1)(ii) and (k)(2)(iv)(A) of this section.

Example 4. The facts are the same as in *Example 3* except A submits the written statement to the Director before a notice of failure to furnish information is mailed to A. The notice is mailed to A on September 7, 2008. Under these facts, the time prescribed for furnishing information under paragraph (i) of this section is September 15, 2008, and the 90-day period after mailing of notice of failure under paragraphs

(k)(1)(ii) and (k)(2)(iv)(A) of this section begins on that same date.

* * * * *

(m) *Effective/applicability dates*. Except as otherwise provided, this section applies with respect to information for annual accounting periods beginning on or after June 21, 2006. Paragraphs (k)(1) and (k)(5) *Examples 3* and *4* of this section apply June 21, 2006.

§§1.6038–2T [Amended]

Par. 3. In §1.6038–2T, paragraphs (e) through (m) are revised to read as follows:

§1.6038–2T Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations (temporary).

* * * * *

(e) through (l) [Reserved]. For further guidance, see §1.6038–2(e) through (l).

(m) *Effective/applicability date*. Paragraph (d) of this section shall apply for taxable years ending after October 22, 2004.

Par. 4. Section 1.6038A–2 is amended by revising paragraphs (b)(8) and (h) to read as follows:

§1.6038A–2 Requirement of return.

* * * * *

(b) * * *

(8) *Accrued payments and receipts*. For purposes of this section, a reporting corporation that uses an accrual method of accounting shall use accrued payments and accrued receipts for purposes of computing the total amount of each of the types of transactions listed in this section.

* * * * *

(h) *Effective/applicability date*. Except as otherwise provided, for effective dates for this section for certain reporting corporations, see §1.6038A–1(n). Paragraph (b)(8) of this section applies with respect to information for annual accounting periods beginning on or after June 21, 2006.

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

Approved July 2, 2007.

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

(Filed by the Office of the Federal Register on July 12, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 13, 2007, 72 F.R. 38475)

Part III. Administrative, Procedural, and Miscellaneous

Transition Relief Regarding the Active Trade or Business Requirement for Certain Transactions

Notice 2007–60

This notice provides transition relief to taxpayers applying § 1.355–3(b)(4)(iii) of the Income Tax Regulations and § 355(b)(2)(C) and (D) of the Internal Revenue Code to certain transactions described in this notice.

SECTION 1. BACKGROUND

Section 355 sets forth the requirements of a tax-free distribution by a corporation of stock of a controlled subsidiary. Section 355(b) conditions the tax-free status of the distribution on the trade or business activities of the relevant corporations and the manner in which those activities were acquired. Generally, § 355(b)(2)(A) provides that a corporation shall be treated as engaged in the active conduct of a trade or business if and only if it is engaged in the active conduct of a trade or business. Section 355(b)(2)(B) requires that the trade or business have been actively conducted throughout the five-year period ending on the date of the distribution (pre-distribution period). Section 355(b)(2)(C) provides that the trade or business must not have been acquired in a transaction in which gain or loss was recognized, in whole or in part, within the pre-distribution period. Section 355(b)(2)(D) provides that control (as defined in § 368(c)) of a corporation which (at the time of acquisition of control) was conducting the trade or business must not have been directly or indirectly acquired by any distributee corporation or by the distributing corporation during the pre-distribution period in a transaction in which gain or loss was recognized, in whole or in part.

SECTION 2. APPLICABILITY OF § 1.355–3(b)(4)(iii)

Section 1.355–3(b)(4)(iii) provides an exception to the general no gain or loss rule in § 355(b)(2)(C) and (D), stating that "[a] direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply. Therefore, in applying section 355(b)(2)(C) or (D), such an acquisition, even though taxable, shall be disregarded." While § 1.355–3(b)(4) is generally applicable to distributions on or before December 15, 1987, the IRS has applied it administratively to distributions occurring after that date, consistent with the amendments to § 355(b)(2)(D) in 1987 and 1988. See Public Law 100–203 (101 Stat. 1330, 1330–411 (1987)) and Public Law 100–647 (102 Stat. 3342, 3605 (1988)).

Section 355(b) was amended again on May 17, 2006. See Section 202 of the Tax Increase Prevention and Reconciliation Act of 2005, Public Law 109–222 (120 Stat. 345, 348) and Section 410 of division A of the Tax Relief and Health Care Act of 2006, Public Law 109–432 (120 Stat. 2922, 2963). This amendment added § 355(b)(3), which provides that a corporation shall be treated as meeting the requirement of § 355(b)(2)(A) if and only if such corporation is engaged in the active conduct of a trade or business. Section 355(b)(3)(B) provides that for purposes of § 355(b)(3)(A) (and, consequently, § 355(b)(2)(A)), all members of such corporation's separate affiliated group (SAG) shall be treated as one corporation.

The IRS and Treasury Department have interpreted § 355(b)(3) as calling into question whether the regulation quoted above appropriately reflects the statute as amended in 2006. See Notice of Proposed Rulemaking, Guidance Regarding the Active Trade or Business Requirement Under Section 355(b), 72 Fed. Reg. 26012 (No. 88) (May 8, 2007) (proposing to modify § 1.355–3) (NPRM). However, consistent with past administrative practice, the IRS will not challenge the applicability of the rule stated in § 1.355–3(b)(4)(iii) to distributions effected on or before the date of publication in the Federal Register of temporary or final regulations modifying the rule stated in § 1.355–3(b)(4)(iii).

SECTION 3. CERTAIN ACQUISITIONS OF ADDITIONAL STOCK OF THE CONTROLLED CORPORATION

Section 355(b)(2)(C) by its terms applies to asset acquisitions while § 355(b)(2)(D) applies to stock acquisitions. The IRS and Treasury Department have interpreted § 355(b)(3) as modifying the applicability of § 355(b)(2)(C) and (D). Section 355(b)(3) essentially treats a stock acquisition that results in the acquired corporation becoming a subsidiary member of the acquiring corporation's SAG as an asset acquisition for purposes of § 355(b). See NPRM. Accordingly, the IRS and Treasury Department have concluded that such a stock acquisition is subject to § 355(b)(2)(C) regardless of whether it results in an acquisition of control that would otherwise be subject to § 355(b)(2)(D). See NPRM.

Acquisitions of stock of the controlled corporation that result in the controlled corporation becoming a member of the distributing corporation's SAG are treated as asset acquisitions that are subject to § 355(b)(2)(C) regardless of whether the distributing corporation already controlled the controlled corporation. Specifically, such an acquisition could violate § 355(b)(2)(C) notwithstanding the fact that it would not violate § 355(b)(2)(D) because there was no acquisition of control.

For example, assume that for more than five years, corporations D and C have each engaged in the active conduct of a trade or business. The trades or businesses are not in the same line of business. Throughout this period, D has owned stock of C constituting control (as defined in § 368(c)) but not meeting the requirements of § 1504(a)(2). In year 6, D purchases for cash the remainder of the C stock from an unrelated party. The purchase of the additional C stock does not violate § 355(b)(2)(D) because D already owned stock of C constituting control. However, because after the purchase D owns stock of C meeting the requirements of § 1504(a)(2), C becomes a member of D's SAG, and D and C are treated as one corporation for purposes of the active trade or business requirement. Accordingly, for § 355(b) purposes, D has

acquired the assets of C in a transaction in which gain or loss was recognized in violation of § 355(b)(2)(C).

Taxpayers may not have anticipated that such acquisitions of additional stock of the controlled corporation would adversely impact the controlled corporation's ability to satisfy the active trade or business requirement. Accordingly, the IRS will not challenge the distributing corporation's (or its SAG's) acquisition of additional stock of the controlled corporation as a violation of § 355(b)(2)(C) with respect to the controlled corporation in the case of distributions effected on or before the date the proposed regulations in the NPRM are published as temporary or final regulations in the Federal Register, provided that the transaction satisfies the requirements of § 355(b)(2)(D) as in effect before the enactment of § 355(b)(3).

SECTION 4. COMMENTS

The IRS welcomes comments on whether similar treatment would be appropriate with respect to any other potential effects of the recent amendments to § 355(b). Comments may be forwarded in the manner provided in the NPRM.

SECTION 5. DRAFTING INFORMATION

The principal authors of this notice are Russell P. Subin and Rubin B. Ranat of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Mr. Subin at (202)–622–7790 or Mr. Ranat at (202) 622–7530 (not toll-free calls).

Extension of Transition Relief for Indian Tribal Government Plans

Notice 2007–67

I. Purpose

The purpose of this notice is to extend the transitional relief provided to plans of Indian tribal governments and certain related entities under Notice 2006–89, 2006–43 I.R.B. 772, to the date that is six months after guidance is issued under § 414(d) of the Code, as amended by section 906 of the Pension Protection Act of 2006, on the determination of whether a retirement plan maintained by an Indian tribal government is a governmental plan with the meaning of § 414(d) of the Code.

II. Background

Section 414(d) of the Code provides that a "governmental plan" includes a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. Certain plans of Indian tribal governments (ITGs) are also governmental plans under § 414(d). Specifically, section 906(a)(1) of the Pension Protection Act of 2006 (PPA '06) amended § 414(d) of the Code with respect to ITG plans to provide that:

> The term 'governmental plan' includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either, and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function).

The provisions of section 906 of PPA '06 apply to plan years beginning on or after August 17, 2006 (PPA's date of enactment). For example, an ITG plan with an October 1 to September 30 plan year is a governmental plan under § 414(d) as amended by PPA '06 only if it satisfies this definition in operation beginning on October 1, 2006.

Notice 2006–89 provides that the Service and Treasury anticipate issuing guidance on § 414(d) as amended and that, until such guidance is issued, an ITG plan will be treated as satisfying the requirements to be a governmental plan under § 414(d) if it complies with those requirements based on a reasonable and good faith interpretation of the amendment made by section 906(a)(1) of PPA '06. Section III.B. of the notice provides certain approaches that, if taken by September 30, 2007, permit separate plans to be established for commercial ITG employees and for other ITG employees who perform essential governmental functions (governmental ITG employees) under the reasonable and good faith compliance standard. Section III.E. indicated that the relief provided in Section III applied pending the issuance of further guidance relating to § 414(d), including the amendment made by section 906(a)(1) of PPA '06. The notice also invited comments from the public on whether additional transition issues need to be addressed.

III. Extension of Transition Relief under Notice 2006–89

Since the issuance of Notice 2006–89, the Service and Treasury have continued to consult with Indian tribal government representatives. Based on those consultations and the comments received in response to Notice 2006–89, and until future guidance is issued, the transition relief provided under Notice 2006–89 is hereby revised so that the date "September 30, 2007" in Section III.B. of Notice 2006–89 is replaced with "the date that is six months after guidance is issued under § 414(d) of the Code, as amended by section 906 of the Pension Protection Act of 2006, on the determination of whether a retirement plan maintained by an ITG is a governmental plan with the meaning of § 414(d)."

This extension is conditioned on the plans involved not being amended, for periods before the extended date, to reduce benefits unless the reduction: (i) does not vary based upon whether the participant is a governmental ITG employee or a commercial ITG employee, or (ii) is made to the plan for commercial ITG employees and is the minimum reduction necessary to satisfy the requirements of the Code. If a reduction occurs that does not meet either of these conditions, the extension provided under this notice ends on the date the reduction goes into effect.

IV. Effect on Other Documents

Notice 2006–89 is modified.

Drafting Information

The principal author of this notice is Diane S. Bloom of the Employee Plans,

Tax Exempt and Government Entities Division. For further information regarding this notice, please call the Employee Plans customer assistance service Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern time at (877) 829–5500 (a toll-free number) or email *RetirementPlanQuestions@irs.gov*.

Weighted Average Interest Rates Update

Notice 2007–68

This notice provides guidance as to the corporate bond weighted average interest rate and the permissible range of interest rates specified under § 412(b)(5)(B)(ii)(II) of the Internal Revenue Code. In addition, it provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II).

CORPORATE BOND WEIGHTED AVERAGE INTEREST RATE

Sections 412(b)(5)(B)(ii) and 412(l)(7)(C)(i), as amended by the Pension Funding Equity Act of 2004 and by the Pension Protection Act of 2006, provide that the interest rates used to calculate current liability and to determine the required contribution under § 412(l) for plan years beginning in 2004 through 2007 must be within a permissible range based on the weighted average of the rates of interest on amounts invested conservatively in long term investment grade corporate bonds during the 4-year period ending on the last day before the beginning of the plan year.

Notice 2004–34, 2004–1 C.B. 848, provides guidelines for determining the corporate bond weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability. That notice establishes that the corporate bond weighted average is based on the monthly composite corporate bond rate derived from designated corporate bond indices. The methodology for determining the monthly composite corporate bond rate as set forth in Notice 2004–34 continues to apply in determining that rate. See Notice 2006–75, 2006–36 I.R.B. 366.

The composite corporate bond rate for July 2007 is 6.33 percent. Pursuant to Notice 2004–34, the Service has determined this rate as the average of the monthly yields for the included corporate bond indices for that month.

The following corporate bond weighted average interest rate was determined for plan years beginning in the month shown below.

For Plan Years Beginning in: Month	Year	Corporate Bond Weighted Average	90% to 100% Permissible Range
August	2007	5.84	5.26 to 5.84

30-YEAR TREASURY SECURITIES INTEREST RATE

Section 417(e)(3)(A)(ii)(II) defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury securities for July 2007 is 5.11 percent. The Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2037.

Drafting Information

The principal authors of this notice are Paul Stern and Tony Montanaro of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 877–829–5500 (a toll-free number), between the hours of 8:30 a.m. and 4:30 p.m. Eastern time, Monday through Friday. Mr. Stern may be reached at 202–283–9703. Mr. Montanaro may be reached at 202–283–9714. The telephone numbers in the preceding sentences are not toll-free.

Relief Related to Plan Amendment of Definition of Normal Retirement Age

Notice 2007–69

I. Purpose

This notice provides temporary relief, until the first day of the first plan year that begins after June 30, 2008, for certain pension plans under which the definition of normal retirement age may be required to be changed to comply with the regulations relating to a plan's normal retirement age that were recently issued under § 401(a) of the Internal Revenue Code. This notice also identifies potential violations of the vesting and accrued benefit requirements for defined benefit plans under § 411 that may arise from a definition of normal retirement age based on a minimum period of service. Finally, this notice requests comments from sponsors of governmental plans as defined in § 414(d)) and other plans not subject to the requirements of § 411 on whether such a plan may define normal retirement age based on years of service.

II. Background

A. Regulations on Definition of Normal Retirement Age

Section 411(a)(8) provides that the term "normal retirement age" means the earlier of (A) the time a plan participant at-

tains normal retirement age under the plan or (B) the later of age 65 or the fifth anniversary of the time a plan participant commenced participation in the plan. A plan's normal retirement age is relevant for a number of purposes, including for purposes of determining the date at which a participant is eligible to receive his or her normal retirement benefit and calculating the amount of the benefit received.

On May 22, 2007, final regulations on distributions from a pension plan upon attainment of normal retirement age were published in the Federal Register as T.D. 9325, 2007–24 I.R.B. 1386 (72 FR 28604) ("2007 regulations"). The 2007 regulations modified § 1.401(a)–1 of the Income Tax Regulations, which generally requires a pension plan to be maintained primarily to provide systematically for the payment of definitely determinable benefits after retirement, by adding in part new paragraphs (b)(2), (3) and (4).

Section 1.401(a)–1(b)(2) of the 2007 regulations provides an exception to the rule that pension benefits be paid only after retirement by permitting a pension plan, as defined in § 1.401–1(a)(2)(i) and § 1.401–1(b)(1)(i), to commence payment of retirement benefits to a participant after the participant has attained normal retirement age even if the participant has not yet had a severance from employment with the employer maintaining the plan.

Section 1.401(a)–1(b)(2)(i) of the 2007 regulations provides, as a general rule, that the normal retirement age under a plan must be an age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

Section 1.401(a)–1(b)(2)(ii) of the 2007 regulations provides, as a safe harbor, that a normal retirement age of at least age 62 is deemed to be not earlier than the typical retirement age for the industry in which the covered workforce is employed. Thus, a plan satisfies this safe harbor if its normal retirement age is age 62, or if its normal retirement age is the later of age 62 or another specified date, such as the later of age 62 or the fifth anniversary of plan participation (but not later than the later of age 65 or the fifth anniversary of plan participation, in the case of a plan subject to § 411).

Section 1.401(a)–1(b)(2)(iii) of the 2007 regulations provides that, if a plan's normal retirement age is between the ages of 55 and 62, the determination of whether the age is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed is based on all of the relevant facts and circumstances. The preamble to the regulations provides that it is generally expected that a good faith determination made by the employer (or, in the case of a multiemployer plan, made by the trustees) that the typical retirement age for the industry in which the covered workforce is employed is an age between age 55 and age 62 will be given deference, assuming that the determination is reasonable under the facts and circumstances.

Section 1.401(a)–1(b)(2)(iv) of the 2007 regulations provides that a normal retirement age that is below age 55 is presumed to be earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed, unless the Commissioner determines that under the facts and circumstances the normal retirement age is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

Section 1.401(a)–1(b)(2)(v) of the 2007 regulations provides that in the case of a plan where substantially all of the participants are qualified public safety employees (within the meaning of § 72(t)(10)(B)), a normal retirement age of age 50 or later is deemed not to be earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered work force is employed.

Section 1.401(a)–1(b)(3) of the 2007 regulations provides that, for purposes of whether a pension plan is maintained primarily to provide systematically for the payment of definitely determinable benefits after retirement, "retirement" does not include a mere reduction in hours worked. Thus, benefits may not be distributed prior to normal retirement age solely due to a reduction in the number of hours that an employee works.

Section 1.401(a)–1(b)(4) of the 2007 regulations provides that paragraphs 1.401(a)–1(b)(2) and (3) are generally effective as of May 22, 2007, the date of their publication in the Federal Register. In the case of a governmental plan (as defined in § 414(d)), paragraphs (b)(2) and (b)(3) are effective for plan years beginning on or after January 1, 2009. In the case of a plan maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on May 22, 2007, paragraphs (b)(2) and (b)(3) do not apply before the first plan year that begins after the last of the agreements terminates determined without regard to any extension thereof (or, if earlier, May 24, 2010).

A provision of a plan that results in the failure of the plan to satisfy § 1.401(a)–1(b)(2) or (3) is a disqualifying provision described in § 1.401(b)–1(b)(3)(i). Therefore, the remedial amendment period rules of § 1.401(b)–1 apply. For example, in the case of a plan with a calendar plan year that is maintained by an employer with a calendar taxable year (and the plan is not a governmental plan and is not maintained pursuant to a collective bargaining agreement), the plan's remedial amendment period with respect to § 1.401(a)–1(b)(2) and (3) ends on the date prescribed by law for the filing of the employer's income tax return (including extensions) for the 2007 taxable year.

Under section 5 of Rev. Proc. 2007–44, 2007–28 I.R.B. 54, the remedial amendment period with respect to § 1.401(a)–1(b)(2) and (3) will be extended to the end of a plan's applicable 5-year or 6-year remedial amendment cycle (described in section 6.01 of Rev. Proc. 2007–44) that includes the date on which the remedial amendment period would otherwise end, if, by that date, the plan sponsor either adopts a good faith interim amendment to comply with § 1.401(a)–1(b)(2) and (3) or reasonably and in good faith determines that no amendment is required. Under § 1.401(b)–1(e)(3), the filing of a determination letter application within a plan's remedial amendment period tolls the running of the period until the end of 91 days after the determination letter is issued.

Section 1.411(d)–4, Q&A–12, of the 2007 regulations provides an exception to the anti-cutback rules of § 411(d)(6) for conforming amendments during a transitional period that ends on the last day of

the plan's applicable remedial amendment period under § 1.401(b)–1. This relief from the anti-cutback rules is limited to the elimination, as a result of an amendment that raises the plan's normal retirement age from one that is inappropriately low to one that satisfies the requirements of § 1.401(a)–1(b)(2), of a participant's right to an in-service distribution at the earlier age. In order to comply with § 411(a) and 411(d)(6), a plan subject to § 411 for which the normal retirement age has been raised to comply with the 2007 regulations must ensure that a participant who became or would have become eligible for payment of benefits at the normal retirement age under the prior plan terms, and who has severed from employment with the employer or employers maintaining the plan, continues to be eligible for payment at the same age and in at least the same amount as under the prior plan terms with respect to benefits accrued prior to the applicable amendment date (within the meaning of § 1.411(d)–3(g)(4)).

Notice 2007–3, 2007–2 I.R.B. 254, contains the 2006 Cumulative List of Changes in Plan Qualification Requirements. This notice provides that the 2007 regulations (which are listed as item 2 in Part V of the notice) will be taken into account in the Service's review of individually designed and multiple employer plans that are submitted for determination letters, and pre-approved defined benefit plans that are submitted for opinion or advisory letters, between February 1, 2007 and January 31, 2008 ("the Cycle B submission period").

B. Impact of Presumption under the 2007 Regulations that Normal Retirement Age Less than Age 55 is not Reasonable

As described above, § 1.401(a)–1(b)(2)(iv) provides that a normal retirement age below age 55 is presumed to be earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed, unless the Commissioner determines otherwise under the facts and circumstances. Some plan sponsors have expressed concern to the Service and Treasury that, although they believe they will be able to demonstrate that their plan's definition of normal retirement age of less than age 55 satisfies the requirements of the 2007 regulations, until they receive a determination to that effect from the Service, the presumption under the regulations that the plan does not satisfy those requirements creates uncertainty. This is of particular concern to sponsors of plans that provide in-service distributions upon attainment of normal retirement age because, if the plan is required to be amended to raise the normal retirement age retroactively, in-service distributions made between the effective date and adoption date of the amendment would not satisfy the plan qualification requirements.

Sponsors of plans that do not provide in-service distributions upon attainment of normal retirement age have also expressed concerns about the immediate effective date of the 2007 regulations. However, uncertainty as to how a plan must be amended to comply with the 2007 regulations may have less effect on current plan operations for these plans, because a plan that does not provide in-service distributions upon attainment of normal retirement age may be amended to retroactively raise the normal retirement age in a way that is consistent with the plan's operation between the effective date and adoption date of the amendment. For example, such a plan may be amended to give participants who sever employment with a vested accrued benefit the right to receive an early retirement benefit upon attainment of the pre-amendment normal retirement age (or severance from employment, if later) in the same amount that would have been paid as the normal retirement benefit if the plan had not been amended. *See* § 1.411(d)–4, Q&A–12(b), for an example of a plan amendment that retroactively raises the plan's normal retirement age without violating § 411(d)(6) or other plan qualification requirements.

The concerns that have been expressed by plan sponsors are illustrated in the case of some plans that define normal retirement age as the earlier of a fixed age or the completion of a lengthy period of service (*e.g.*, 30 years). The sponsors of these plans have asserted that the normal retirement age under their plan is the typical retirement age for the industry in which the covered workforce is employed, even though it is possible for participants to attain the normal retirement age as early as age 47 or 48. These sponsors have stated that the immediate effective date of the 2007 regulations may lead employers, particularly those that sponsor plans that offer in-service distributions upon attainment of normal retirement age, to take unnecessary action if the plan is later found upon review by the Service to have a normal retirement age that is reasonably representative of the industry in which the covered workforce is employed.

In response to these concerns, the Service and Treasury are providing the temporary relief described below in Part III of this notice.

III. Relief Provided

Two forms of relief are provided, as described in sections A and B, below. The relief is available to plans that meet the eligibility requirements in section A or B, and that might otherwise be required to be amended to raise the plan's normal retirement age effective before the first day of the first plan year beginning after June 30, 2008, in order to satisfy the 2007 regulations. Thus, the relief does not apply to governmental plans, but it does apply to a plan maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on May 22, 2007, if the first plan year beginning after the last of the agreements terminates (determined without regard to any extension thereof) begins before July 1, 2008.

A. Temporary Relief for Plans with Normal Retirement Age Lower Than Age 62

The Service will not propose to disqualify a plan solely because the plan fails to satisfy the requirements of § 1.401(a)–1(b)(2) and (3) if the plan satisfies the following conditions:

1. The plan, immediately prior to May 22, 2007, provided a definition of normal retirement age that was earlier than age 62.
2. No possible plan participant hired at age 18 or older could attain the plan's normal retirement age before the age of 40.
3. Unless the plan sponsor reasonably and in good faith determines that no amendment is necessary,

the sponsor adopts a good faith interim amendment to comply with § 1.401(a)–1(b)(2) and (3) effective no later than the first day of the first plan year beginning after June 30, 2008, and the plan is operated in compliance with such amendment as of the amendment's effective date.

4. The plan sponsor adopts the interim amendment by the later of (a) the last day of the first plan year beginning after June 30, 2008, or (b) the due date (including extensions) for filing the employer's income tax return for the employer's taxable year that includes the first day of the first plan year beginning after June 30, 2008. (In the case of a tax exempt employer, *see* section 5.06(2) of Rev. Proc. 2007–44 for the rules for determining the employer's tax filing deadline for this purpose.)

In addition, relief is provided for the rare and unusual circumstance where the plan sponsor has acted in good faith in making a determination that the plan's normal retirement age is not earlier than the typical retirement age for the industry in which the covered workforce is employed, but the plan's normal retirement age actually is earlier than the typical retirement age for the industry in which the covered workforce is employed. In such a case, if the plan sponsor applies for a determination letter within the applicable remedial amendment cycle, the Service will require corrective action to be taken prospectively only from the date of issuance of the determination letter, so that the plan's normal retirement age will not be required to be raised retroactively. For this purpose, "the applicable remedial amendment cycle" is the plan's remedial amendment cycle under Rev. Proc. 2007–44 that includes the interim amendment deadline determined under condition 4, above. Any plan amendment that is determined to be necessary to comply with § 1.401(a)–1(b)(2) and (3) will not be required to be adopted earlier than the 91st day after the date of the Service's determination letter. The relief under this paragraph applies only if the plan's normal retirement age is not earlier than age 55.

B. Temporary Presumption of Reasonableness for Plans with Normal Retirement Age Lower Than Age 55

Eligible plans with a normal retirement age lower than 55 will temporarily be accorded the same presumption as plans with a normal retirement age between age 55 and 62. Thus, for periods prior to the date on which the Service rules on an eligible plan's normal retirement age, the plan sponsor's good faith determination of the typical retirement age for the industry in which the covered workforce is employed will generally be given deference, assuming that the determination is reasonable under the facts and circumstances.

A plan is eligible for the relief under this Part III.B if it satisfies the following conditions:

1. The plan, immediately prior to May 22, 2007, provided a definition of normal retirement age that was earlier than age 55.
2. No possible plan participant hired at age 18 or older could attain the plan's normal retirement age before the age of 40.
3. The plan sponsor submits a request for a letter ruling on whether its definition of normal retirement age satisfies the standard in the 2007 regulations, in accordance with the procedures described in Part IV below, by June 30, 2008.

If the Service determines during the ruling process that the plan's normal retirement age does not reasonably represent the typical retirement age for the industry in which the covered workforce is employed, the Service will require corrective action to be taken prospectively only from the date of issuance of the ruling letter, so that the plan's normal retirement age will not be required to be raised retroactively. In addition, for purposes of § 401(b) and the regulations thereunder, the letter ruling request will be treated as an application for a determination letter on the qualification of the plan, so that any plan amendment that is determined to be necessary to comply with § 1.401(a)–1(b)(2) and (3) will not be required to be adopted earlier than the 91st day after the date of the Service's ruling.

IV. Application Procedures for Letter Ruling on Definition of Normal Retirement Age

An application for a letter ruling as to whether a plan's normal retirement age reasonably represents the typical retirement age for the industry in which the covered workforce is employed is to be made in accordance with the procedures governing letter rulings requests in Rev. Proc. 2007–4, 2007–1 I.R.B. 118. The request must include the user fee for a letter ruling under section 6.01(10) of Rev. Proc. 2007–8, 2007–1 I.R.B. 230.

The statement and analysis of facts of the letter ruling request must:

1. Indicate whether and when a determination letter for the plan with respect to the plan's current remedial amendment cycle has been or will be filed.
2. Describe the industry in which the covered workforce is generally employed.
3. Identify the sources and date of compilation of data that was used in determining the typical retirement age for the industry, which may include data concerning employee retirement from the plan sponsor. (It is expected that the data will include the actual ages of termination of employment of career employees, *i.e.*, employees whose principal career has been in the employment of the plan sponsor.)
4. Present and analyze the data the plan sponsor used to determine the typical retirement age.
5. Describe any other relevant information (whether or not used by the plan sponsor in determining the typical retirement age).

The Service reserves the right to request any other information it considers necessary.

V. Application of Accrual Rules in the Case of Normal Retirement Age Based on Years of Service

The 2007 regulations do not provide a safe harbor or other guidance with respect to a normal retirement age that is conditioned (directly or indirectly) on the completion of a stated number of years of service. The Service and Treasury expect

that a plan under which a participant's normal retirement age changes to an earlier date upon completion of a stated number of years of service typically will not satisfy the vesting or accrual rules of § 411. See, *e.g.*, § 1.411(b)–1(b)(2)(ii)(F). The relief described in Part III of this notice is limited to compliance with the 2007 regulations and thus, for example, does not extend to any violation of § 411(a)(1) or 411(b)(1) that may arise from a plan's definition of normal retirement age as other than a stated age.

The fact that plans are limited in their ability to provide a normal retirement age that is based on completion of a stated number of years of service does not mean that plans cannot provide benefits that are based on completion of a stated number of years of service. For example, an early retirement benefit, including an unreduced early retirement benefit, is permitted to be conditioned on completion of a stated number of years of service (such as 30 years of service). However, an early retirement benefit is generally only permitted to commence with an annuity starting date that is after severance from employment (except to the extent permitted under § 401(a)(36), as added by the Pension Protection Act of 2006, Pub. L. 109–280).

VI. Request for Comments

Sponsors of governmental plans and other plans not subject to the requirements of § 411 are asked to submit comments on whether normal retirement age under such a plan may be based on years of service. Comments are requested on whether and how a pension plan with a normal retirement age conditioned on the completion of a stated number of years of service satisfies the requirement in § 1.401(a)–1(b)(1)(i) that a pension plan be maintained primarily to provide for the payment of definitely determinable benefits after retirement or attainment of normal retirement age and how such a plan satisfies the pre-ERISA vesting rules. Comments should be submitted by November 25, 2007, to CC:PA:LPD:PR (Notice 2007–69), Room 5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2007–69), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. Alternatively, comments may be submitted via the Internet at *Notice.comments@irscounsel.treas.gov*. Please include "Notice 2007–69" in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

VII. Effect on Other Documents

Rev. Proc. 2007–4 is modified.

Notice 2007–3 is modified to provide that the 2007 regulations will be taken into account in the Service's review of a plan that is submitted for a determination letter during the Cycle B submission period only if the plan is an individually designed or a multiple employer plan that, by its terms, is not eligible for the relief in this notice. Thus, for example, the 2007 regulations will be taken into account in the Service's review of an individually designed or a multiple employer plan that is submitted during the Cycle B submission period if, under the plan, a participant hired at age 18 or older could attain the plan's normal retirement age before the age of 40. The 2007 regulations will also be taken into account in the Service's review of pre-approved defined benefit plans that are submitted for opinion or advisory letters during the Cycle B submission period.

Drafting Information

The principal authors of this notice are Diane S. Bloom and James P. Flannery of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans taxpayer assistance answering service Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern time at 1–877–829–5500 (a toll-free call) or e-mail *RetirementPlanQuestions@irs.gov*.

Modification of Notice 2003–81

Notice 2007–71

This notice modifies and supplements Notice 2003–81, 2003–2 C.B. 1223, by correcting a statement in the "Facts" portion of Notice 2003–81.

BACKGROUND

On December 4, 2003, the Internal Revenue Service ("Service") and the Treasury Department ("Treasury") published Notice 2003–81, which described a tax avoidance transaction involving offsetting foreign currency options and identified such transaction and those substantially similar to it as listed transactions for purposes of § 1.6011–4(b)(2) of the Income Tax Regulations and §§ 301.6111–2(b)(2) and 301.6112–1(b)(2) of the Procedure and Administration Regulations.

In the transaction described in Notice 2003–81, a taxpayer pays premiums to purchase a call option and a put option (the purchased options) on a foreign currency in which positions are traded through regulated futures contracts. The purchased options are reasonably expected to move inversely in value to one another over a relevant range, thus ensuring that, as the value of the underlying foreign currency changes, the taxpayer will hold a loss position in one of the two purchased options. The taxpayer also receives premiums for writing a call option and a put option (the written options) on a different foreign currency in which positions are not traded through regulated futures contracts. The taxpayer takes the position that the written options are neither foreign currency contracts within the meaning of § 1256(g)(2)(A) nor § 1256 contracts within the meaning of § 1256(b). The written options are reasonably expected to move inversely in value to one another over a relevant range, thus ensuring that, as the value of the underlying foreign currency changes, the taxpayer will hold a gain position in one of the two written options.

The values of the two currencies underlying the purchased and written options (i) historically have demonstrated a very high positive correlation with one another, or (ii) officially have been linked to one another, such as through the European Exchange Rate Mechanism (ERM II). Thus, as the currencies change in value, the taxpayer reasonably expects to have the following potential gains and losses in substantially offsetting positions: (1) a loss in a purchased option and a gain in a written

option; and (2) a gain in a purchased option and a loss in a written option. At any time, the taxpayer's loss in the purchased option position that has declined in value may be more or less than the taxpayer's gain in the offsetting written option position that has appreciated in value. Similarly, the taxpayer's gain in the remaining purchased option position may be more or less than the taxpayer's loss in the remaining written option position. A material pre-tax profit or rate of return, or both, on the transaction is possible but unlikely.

The taxpayer assigns to a charity the purchased option that has a loss. The charity also assumes the taxpayer's obligation under the offsetting written option that has a gain. The premium received on that written option is not assigned but is retained by the taxpayer. As with all written options, the amount of gain on the option is limited to the premium received for the option. In the same tax year, the taxpayer may dispose of the remaining purchased option and offsetting written option.

Because the taxpayer takes the position that the purchased option assigned to the charity is a § 1256 contract, the taxpayer relies on § 1256(c) and Greene v. United States, 79 F.3d 1348 (2d Cir. 1996) to mark to market the purchased option when the option is assigned to the charity and to recognize a loss at that time. In contrast, because the taxpayer takes the position that the assumed written option is not a § 1256 contract, the taxpayer claims not to recognize gain attributable to the option premium. Specifically, the taxpayer claims that the charity's assumption of the option obligation does not cause the taxpayer to recognize gain and that the taxpayer also does not recognize gain either at the time the option expires or terminates or at any other time.

ANALYSIS

Although as a general matter the "Facts" portion of Notice 2003–81 correctly describes the transaction at issue, it includes an erroneous conclusion of law. The second sentence in the "Facts" portion of Notice 2003–81 states: "The currency is one in which positions are traded through regulated futures contracts, and the purchased options, therefore, are foreign currency contracts within the meaning of § 1256(g)(2)(A) of the Internal Revenue Code and § 1256 contracts within the meaning of § 1256(b)."

This sentence should have stated "The taxpayer takes the position that the purchased options are foreign currency contracts within the meaning of § 1256(g)(2)(A) of the Internal Revenue Code and § 1256 contracts within the meaning of § 1256(b)." The Service and Treasury do not believe that foreign currency options, whether or not the underlying currency is one in which positions are traded through regulated futures contracts, are foreign currency contracts as defined in § 1256(g)(2), and intend to challenge any such characterization by taxpayers.

Section 1256(g)(2)(A) defines a foreign currency contract, in part, as a contract that requires delivery of, *or the settlement of which depends on the value of*, certain foreign currencies. The original statutory definition, however, did not allow for cash settlement and required actual delivery of the underlying foreign currency in all circumstances. Options, by their nature, only require delivery if the option is exercised. Section 102 of the Tax Reform Act of 1984, P.L. 98–369, 1984–3 (Vol. 1) C.B. 128, added the clause "or the settlement of which depends on the value of." There is no indication, however, that Congress intended by this addition to extend the definition of "foreign currency contract" to foreign currency options. That conclusion is confirmed by the legislative history to § 988(c)(1)(E), enacted by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100–647, 1988–3 C.B. 377–380, which indicates that a foreign currency option is not a foreign currency contract as defined in § 1256(g)(2).

Subject to the following, § 7805(b) relief is granted to taxpayers that adopted an accounting method in reasonable reliance on Notice 2003–81 to treat over-the-counter foreign currency options as foreign currency contracts as defined in § 1256(g)(2). Section 7805(b) relief is not granted with respect to options entered into in transactions that are the same or substantially the same as those described in Notice 2003–81. Further, § 7805(b) relief is not granted with respect to options entered into in any transaction identified as a listed transaction for purposes of §§ 1.6011–4(b)(2), 301.6111–2(b)(2) and 301.6112–1(b)(2).

The principal authors of this notice are Mark E. Erwin of the Office of Associate Chief Counsel (International) and Patrick E. White of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Mark E. Erwin at (202) 622–3870 or Patrick E. White at (202) 622–3920 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Withdrawal of Proposed Regulations

Qualified Zone Academy Bonds; Obligations of States and Political Subdivisions

REG–121475–03

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9339) relating to the Federal income tax treatment of qualified zone academy bonds. This document contains proposed regulations that provide guidance to state and local governments that issue qualified zone academy bonds and to banks, insurance companies, and other taxpayers that hold those bonds on the program requirements for qualified zone academy bonds. The regulations implement the amendments to section 1397E of the Internal Revenue Code (Code) and provide guidance on the maximum term, permissible use of proceeds, and remedial actions for qualified zone academy bonds. The text of those regulations also serves as the text of these proposed regulations. This document also withdraws proposed regulations (REG–121475–03, 2004–1 C.B. 793) published March 26, 2004.

DATES: Written or electronic comments and requests for a public hearing must be received by October 15, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–121475–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–121475–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *http://www.regulations.gov/* (IRS REG–121475–03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Zoran Stojanovic, (202) 622–3980; concerning submissions of comments and/or requests for a hearing, Richard A. Hurst, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these proposed regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1908. Responses to this collection of information are required to obtain or retain a benefit. This collection of information is required by the IRS to verify compliance with section 1397E. Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP; Washington, DC 20224. Comments on the collection of information should be received by September 14, 2007. Comments are specifically requested concerning:

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

The accuracy of the estimated burden associated with the proposed collection of information;

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

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

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

The collection of information in this proposed regulation is in §1.1397E–1(h). This collection of information is required by the IRS to verify compliance with section 1397E. This information will be used to identify issuers of qualified zone academy bonds that have established a defeasance escrow as a remedial action taken because of failure to satisfy certain requirements of section 1397E. The collection of information is required to obtain or retain a benefit. The likely respondents are states or local governments that issue qualified zone academy bonds.

Estimated total annual reporting burden: 3 hours.

Estimated average annual burden hours per respondent: 30 minutes.

Estimated number of respondents: 6.

Estimated annual frequency of responses: varies.

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

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

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 1397E. The temporary regulations amend the final regulations adopted September 26, 2000 (T.D. 8903, 2000–2 C.B. 352 [65 FR 57732]), and provide guidance to state and local governments that issue qualified zone academy bonds and to bank, insur-

ance companies, and other taxpayers that hold those bonds. The temporary regulations provide guidance on the program requirements for qualified zone academy bonds. 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 these proposed regulations.

Special Analyses

It has been determined that this notice of proposed rule rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. It is estimated that each year six issuers of QZABs will be required to report the establishment of a defeasance escrow, and the average estimated burden of each such reporting is 30 minutes. In addition, the establishment of a defeasance escrow need only be reported once. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue 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 specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing 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 authors of these regulations are Timothy L. Jones and Zoran Stojanovic, Office of Division Counsel/Associate Chief Counsel, IRS (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

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Withdrawal of Proposed Regulations

Under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–121475–03) published in the **Federal Register** on March 26, 2004 (69 FR 15747) is withdrawn.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.1397E–1 also issued under 26 U.S.C. 1397E. * * *

Par. 2. Section 1.1397E–1 is amended by revising paragraphs (a), (d), (h), (i), (j), (k), (l), and (m) to read as follows:

§1.1397E–1 Qualified zone academy bonds.

(a) [The text of the proposed amendment to §1.1397E–1(a) is the same as the text of §1.1397E–1T(a) published elsewhere in this issue of the Bulletin].

* * * * *

(d) [The text of the proposed amendment to §1.1397E–1(d) is the same as the text of §1.1397E–1T(d) published elsewhere in this issue of the Bulletin].

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(h) [The text of the proposed amendment to §1.1397E–1(h) is the same as the text of §1.1397E–1T(h) published elsewhere in this issue of the Bulletin].

(i) [The text of the proposed amendment to §1.1397E–1(i) is the same as the text of §1.1397E–1T(i) published elsewhere in this issue of the Bulletin].

(j) [The text of the proposed amendment to §1.1397E–1(j) is the same as the text of §1.1397E–1T(j) published elsewhere in this issue of the Bulletin].

(k) [The text of the proposed amendment to §1.1397E–1(k) is the same as the text of §1.1397E–1T(k) published elsewhere in this issue of the Bulletin].

(l) [The text of the proposed amendment to §1.1397E–1(l) is the same as the text of §1.1397E–1T(l) published elsewhere in this issue of the Bulletin].

(m) [The text of the proposed amendment to §1.1397E–1(m) is the same as the text of §1.1397E–1T(m)(1) and (m)(2) published elsewhere in this issue of the Bulletin].

* * * * *

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

(Filed by the Office of the Federal Register on July 13, 2007, 8:45 a.m., and published in the issue of the Federal Register for July 16, 2007, 72 F.R. 38802)

Announcement of Disciplinary Actions Involving Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries — Reinstatements, Suspensions, Censures, Disbarments, and Resignations

Announcement 2007-72

Under Title 31, Code of Federal Regulations, Part 10, attorneys, certified public accountants, enrolled agents, and enrolled actuaries may not accept assistance from, or assist, any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter constituting practice before the Internal Revenue Service and may not knowingly aid or abet another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility, will announce in the Internal Revenue Bulletin their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Reinstatement To Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, The Director, Office of Professional Responsibility, may entertain a petition for reinstatement for any attorney, certified public accountant, enrolled agent, or enrolled actuary censured, suspended, or disbarred, from practice before the Internal Revenue Service.

The following individuals' eligibility to practice before the Internal Revenue Service has been restored:

Name	Address	Designation	Date of Reinstatement
Mollo, Charles W.	Anaheim, CA	EA	December 1, 2004
Price, Richard A.	Novato, CA	CPA	April 29, 2005
Reyes, Ruperto D.	Placentia, CA	CPA	December 8, 2005
Schwartz, Kenneth J.	West Hills, CA	Attorney	February 28, 2006
McCarthy III, William P.	Sacramento, CA	EA	March 10, 2006
Deen, Mae T.	Salinas, CA	EA	April 16, 2006
Banks, Jean R.	Van Nuys, CA	EA	December 6, 2006
Eckstein, Matthew	Woodbury, NY	CPA	March 14, 2007
Cunningham, William	Philadelphia, PA	CPA	March 31, 2007
Ganz, Sheldon M.	Great Neck, NY	CPA	April 19, 2007
Smith, Sean M.	Kensington, MD	Enrolled Agent	April 27, 2007
Frascella, Russell B.	Pound Ridge, NY	CPA	April 27, 2007
Lamont, Alice	Atlanta, GA	CPA	May 4, 2007
Carroccio, Ronald P.	Staten Island, NY	CPA	May 15, 2007
Cohen, Ronald J.	Cornwall, NY	Attorney	June 21, 2007
Troese, Jr., Henry A.	Clarion, PA	Enrolled Agent	June 25, 2007

Name	Address	Designation	Date of Reinstatement
Jacob, Robert T.	Tucson, AZ	Enrolled Agent	June 27, 2007
Simontacchi, Joseph F.	Rockaway, NJ	CPA	July 3, 2007
Kimes, Larry W.	Irving, TX	CPA	July 6, 2007

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent, or enrolled actuary in accordance with the consent offered.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Caplan, Howard A.	Ocean, NJ	CPA	Indefinite from April 1, 2007
Tow, Marc R.	Newport Beach, CA	Attorney	Indefinite from April 1, 2007
Pyburn, Richard E.	Downers Grove, IL	CPA	Indefinite from April 9, 2007
Cook, Jack D.	South Haven, MI	CPA	Indefinite from April 17, 2007
Serban, Daniel E.	Roanoke, IN	Attorney	Indefinite from April 19, 2007
Wentz, Debora B.	Newton, NC	CPA	Indefinite from April 19, 2007
Ferguson, Duane F.	Upland, CA	CPA	Indefinite from May 1, 2007
Mulrey, Robert M.	Milton, MA	CPA	Indefinite from May 1, 2007
Colasuonno, Philip V.	New Rochelle, NY	CPA	Indefinite from May 23, 2007
Bankston, David A.	Land O Lakes, FL	CPA	Indefinite from June 1, 2007

Name	Address	Designation	Date of Suspension
Nagy, Robert J.	Charleston, SC	CPA	Indefinite from June 1, 2007
Wallen, David G.	Beckley, WV	CPA	Indefinite from June 15, 2007
Rudick, Josephine M.	Bear Creek, PA	Enrolled Agent	Indefinite from June 25, 2007
Iglesias, Jorge E.	Roswell, GA	CPA	Indefinite from July 1, 2007
Raimer, Russell B.	Brecksville, OH	CPA	Indefinite from July 1, 2007
Stancukas, Stanley J.	Forth Worth, TX	CPA	Indefinite from July 1, 2007

Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions:

Name	Address	Designation	Date of Suspension
Barach, Malcolm J.	Brookline, MA	Attorney	Indefinite from March 9, 2007
Cox, Marlisa R.	Oklahoma City, OK	CPA	Indefinite from April 2, 2007
Artis, Paris A.	Newberry, FL	Attorney	Indefinite from April 13, 2007
Blackadar, Christine M.	Center Harbor, NH	Attorney	Indefinite from April 13, 2007
Brelje, Brian J.	Laguna Beach, CA	CPA	Indefinite from April 13, 2007

Name	Address	Designation	Date of Suspension
Decker, Craig A.	Mesa, AZ	Attorney	Indefinite from April 13, 2007
House, Stephen M.	Nevada City, CA	CPA	Indefinite from April 13, 2007
Laird, James J.	San Ramon, CA	CPA	Indefinite from April 13, 2007
Milner, Dennis V.	Dublin, CA	Attorney	Indefinite from April 13, 2007
Nutt, Jeremy C.	Forth Worth, TX	Attorney	Indefinite from April 13, 2007
Picl, Frank M.	Peoria, IL	Attorney	Indefinite from April 13, 2007
Britt, Jerry U.	Mount Olive, NC	CPA	Indefinite from April 19, 2007
Lee, Janell M.	Oakland, CA	CPA	Indefinite from April 19, 2007
Baker, Sean W.	Elkridge, MD	Attorney	Indefinite from April 30, 2007
Brett, Stephen M.	York Beach, ME	Attorney	Indefinite from April 30, 2007
Donahue, Richard K.	Lowell, MA	CPA	Indefinite from April 30, 2007
Frank, Mack I.	Eunice, LA	Attorney	Indefinite from April 30, 2007
Leung, Elsie Y.	Pasadena, CA	CPA	Indefinite from April 30, 2007
Pearlman, Stephen E.	Dix Hills, NY	Attorney	Indefinite from April 30, 2007
Peer, Jameelah	Waimanalo, HI	Attorney	Indefinite from April 30, 2007

Name	Address	Designation	Date of Suspension
Riskowski, Patrick T.	Omaha, NE	Attorney	Indefinite from April 30, 2007
Schumacher, Mary M.	Dubuque, IA	Attorney	Indefinite from April 30, 2007
DeVaughn, Donald L.	Plainview, MN	Attorney	Indefinite from May 1, 2007
Waggle, Stephen L.	Los Banos, CA	CPA	Indefinite from May 24, 2007
Nefsky, Melvyn I.	Los Angeles, CA	CPA	Indefinite from June 11, 2007
Neuendorf, Louis E.	Sandwich, IL	Attorney	Indefinite from June 11, 2007
Thomas, Scott C.	Parker, CO	Attorney	Indefinite from June 11, 2007
Todd, Donald J.	South Holland, IL	CPA	Indefinite from June 11, 2007
Winrow, Wayne	Emeryville, CA	Attorney	Indefinite from June 11, 2007
Cannon, Todd R.	Florence, CO	Attorney	Indefinite from June 12, 2007
Hester, Karen H.	Overland Park, KS	Attorney	Indefinite from June 25, 2007
Denman, Dwight E.	Dallas, TX	Attorney	Indefinite from June 25, 2007
Korcan, Barry	Loretto, PA	CPA	Indefinite from June 25, 2007
Lloyd, Max C.	South Jordan, UT	CPA	Indefinite from June 25, 2007
White, Lanny R.	Lindon, UT	CPA	Indefinite from June 25, 2007
Bjorklund, Dennis A.	Coralville, IA	Attorney	Indefinite from June 28, 2007

Name	Address	Designation	Date of Suspension
Noel, Robert	Fairfield, CA	Attorney	Indefinite from June 28, 2007
Sanger, Susan L.	Greenwood Village, CO	Attorney	Indefinite from June 28, 2007
Shatzen, Robert S.	Beaverton, OR	Attorney	Indefinite from June 28, 2007
Stevenson, Albert D.	Olive Branch, MS	CPA	Indefinite from June 28, 2007
Van Beek, Andrea	Orange City, IA	Attorney	Indefinite from June 28, 2007
Sojcher, Stuart H.	Winchester, MA	Attorney	Indefinite from July 3, 2007
Estrada, Severo C.	San Jose, CA	CPA	Indefinite from July 3, 2007
Ferguson, Robert E.	Salt Point, NY	Attorney	Indefinite from July 3, 2007
Wickenkamp, Mary C.	Denison, TX	Attorney	Indefinite from July 3, 2007

Suspensions From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been placed under suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Cettomai, Joseph W.	Rootstown, OH	CPA	Indefinite from April 19, 2007

Disbarments From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been disbarred from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Haynes, Scott Y.	Valdosta, GA	CPA	March 19, 2007

Censure Issued by Consent

Under Title 31, Code of Federal Regulations, Part 10, in lieu of a proceeding being instituted or continued, an attorney, certified public accountant, enrolled agent, or enrolled actuary, may offer his or her consent to the issuance of a censure. Censure is a public reprimand.

The following individuals have consented to the issuance of a Censure:

Name	Address	Designation	Date of Censure
Lyons, John K.	Dingmans Ferry, PA	Attorney	April 4, 2007
Bowman, T. Hardie	Corpus Christi, TX	CPA	May 23, 2007
Kofford, Brian T.	Provo, UT	CPA	June 12, 2007

Resignations of Enrolled Agents

Under Title 31, Code of Federal Regulations, Part 10, an enrolled agent, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her resignation as an enrolled agent. The Director, Office of Professional Responsibility, in his discretion, may accept the offered resignation.

The Director, Office of Professional Responsibility, has accepted offers of resignation as an enrolled agent from the following individuals:

Name	Address	Date of Resignation
Hancock, William H.	Plant City, FL	April 10, 2007

Unified Rule for Loss on Subsidiary Stock; Correction

Announcement 2007–74

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking.

SUMMARY: This document contains corrections to a notice of proposed rulemaking (REG–157711–02, 2007–8 I.R.B. 537) that was published in the **Federal Register** on Tuesday, January 23, 2007 (72 FR 2964). These regulations apply to corporations filing consolidated returns. The regulations implement aspects of the repeal of the *General Utilities* doctrine by redetermining members' bases in subsidiary stock and requiring certain reductions in subsidiary stock basis on a transfer of the stock. The regulations promote the clear reflection of income by redetermining members' bases in subsidiary's stock and reducing the subsidiary's attributes to prevent the duplication of loss, and they also, provide guidance limiting the application of section 362(e)(2) with respect to transactions between members of a consolidated group.

FOR FURTHER INFORMATION CONTACT: Theresa Abell (202) 622–7700 or Phoebe Bennett (202) 622–7770 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking (REG–157711–02) that is the subject of these corrections is under sections 358, 362(e)(2) and 1502 of the Internal Revenue Code.

Need for Correction

As published, the notice of proposed rulemaking (REG–157711–02) contains errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the notice of proposed rulemaking (REG–157711–02), that is the subject of FR Doc. 07–187, is corrected as follows:

1. On page 2964, column 2, in the preamble, under the paragraph heading "Paperwork Reduction Act", eighth paragraph of the column, line 3, the language "13(e)(4)(v) and 1.1502–36(d)(7). The" is corrected to read "13(e)(4)(v) and 1.1502–36(d)(6). The".

2. On page 2964, column 3, in the preamble, under the paragraph heading "Background", second paragraph of the column, line 10, the language "*v. United States*, 255 F.3d 1357 (2001)," is corrected to read "*v. United States*, 255 F.3d 1357 (Fed. Cir. 2001),".

3. On page 2965, column 1, in the preamble, under the paragraph heading "2. The Administrative Response to GU Repeal: §1.1502–20.", first paragraph, line 2 from bottom of the paragraph, the language "determine adjustments to member's" is corrected to read "determine adjustments to members'".

4. On page 2972, column 1, in the preamble, under the paragraph heading "2. Hybrid Tracing-Presumptive Model: Asset Tracing.", first paragraph, line 3, the language "presumption approach that would" is corrected to read "presumptive approach that would".

5. On page 2972, column 2, in the preamble, the paragraph heading "3. Presumption-Based Models" is corrected to read "3. Presumptive-Based Models.".

6. On page 2975, column 1, in the preamble, under the paragraph heading "d. *Netting of items from different tax periods.*", first paragraph, line 6, the language, "investments were not. The IRS and" is corrected to read "investment adjustments were not. The IRS and".

7. On page 2975, column 1, in the preamble, under the paragraph heading "d. *Netting of items from different tax periods.*", second paragraph, line 8, the language, "account by the group. Thus, IRS and" is corrected to read "account by the group. Thus, the IRS and".

8. On page 2975, column 2, in the preamble under the paragraph heading "e. *Summary and conclusions.*", second paragraph, line 12 from the bottom of the paragraph, the language "administrative and other concerns" is corrected to read "administrative burden and other concerns".

9. On page 2977, column 1, in the preamble, under the paragraph heading "*E. Noneconomic and Duplicated Loss From Investment Adjustment System.*", first paragraph, line 2, the language "preamble, IRS and Treasury Department" is corrected to read "preamble, the IRS and Treasury Department".

10. On page 2978, column 3, under paragraph heading "1. Overview.", third paragraph of the column, line 4 from the bottom of the paragraph, the language "implement a loss limitation approach" is correct to read "implements a loss limitation approach".

11. On page 2980, column 1, under paragraph heading "4. The Attribute Reduction Rule.", second paragraph, lines 16 and 17, the language "the value of all of the S shares. Net the inside attributes generally has the same" is corrected to read "the value of all the S shares. The term net inside attributes generally has the same".

12. On page 2980, column 1, under paragraph heading "4. The Attribute Reduction Rule.", third paragraph, last line of the column, the language "stock loss for a later recognition (for" is corrected to read "stock loss for later recognition (for".

13. On page 2980, column 2, under paragraph heading "4. The Attribute Reduction Rule.", second paragraph of the column, lines 1 and 2 from bottom of the paragraph, the language "attributes are reduced reflects this principle." is corrected to read "attributes are reduced reflects these principles.".

14. On page 2980, column 3, under subparagraph heading "a. *Special rules applicable when S holds stock of lower-tier subsidiary.*", second paragraph, line 16, the language "inside attributes. For example, if P owns" is corrected to read "inside attributes. For example, assume P owns".

15. On page 2981, column 3, under subparagraph heading "b. *Election to reduce stock basis and/or reattribute loss.*", first paragraph of the column, line 22 from bottom of the paragraph, the language "transaction. Proposed regulations under" is corrected to read "transaction."

16. On page 2981, column 3, under subparagraph heading "b. *Election to reduce stock basis and/or reattribute loss.*", second paragraph, line 21 from bottom of the paragraph, the language "§1.1502–32 treat the reattributed" is corrected and

added with new paragraph to read "Proposed regulations under §1.1502–32 treat the reattributed ".

17. On page 2982, column 1, under subparagraph heading "6. Special Rules for Section 362(e)(2) Transaction.", second paragraph, lines 1 and 2 from bottom of the column, the language "under section 362(e)(2)(C) been made Similarly, to adjust for distortions" is corrected to read "under section 362(e)(2)(C) been made. Similarly, to adjust for distortions".

18. On page 2982, column 2, under subparagraph heading "6. Special Rules for Section 362(e)(2) Transaction.", second paragraph of the column, line 9 from the bottom of the paragraph, the language, "stock basis and net inside attributes that" is corrected to read "stock basis, net inside attributes, and value that".

19. On page 2983, column 2, under subparagraph heading "2. Suspension of Section 362(e)(2) for Intercompany Transactions.", last paragraph of the column, line 2 from bottom of the column, the language "investment adjustment system has not" is corrected to read "investment adjustment system has not eliminated".

20. On page 2984, column 2, under subparagraph heading "4. Application of Section 362(e)(2) to Intercompany Transactions.", first paragraph of the column, line 7 from the bottom of the paragraph, the language "attributes is applied to proportionately" is corrected to read "attributes is applied proportionately".

21. On page 2984, column 3, under subparagraph heading "5. Special Allocations Under §1.1502–32.", line 7 of the paragraph, the language "entirely to member's shares. In other" is corrected to read "entirely to members' shares. In other".

22. On page 2986, column 2, under subparagraph heading, "8. Retention of, and Nonsubstantive Revisions to, §1.1502–80(c).", third paragraph of the column, line 8 of the paragraph, the language "under the LDR and, since LDR no longer" is corrected to read "under the LDR and, since the LDR no longer".

23. On page 2986, column 3, under subparagraph heading, "8. Retention of, and Nonsubstantive Revisions to, §1.1502–80(c).", first paragraph of the column, line 2 of the column, the language "deduction. See, *In re Prudential Lines*," is corrected to read "deduction. See *In re Prudential Lines*,".

§1.1502–13 [Corrected]

24. On page 2988, column 1, §1.1502–13(e)(4)(ii)(C)(*2*), line 12 from bottom of the column, the language "otherwise is eliminated (other than" is corrected to read "otherwise eliminated (other than".

25. On page 2989, column 3, §1.1502–13(e)(4)(vi), *Example 3*.(iv), line 18 of the paragraph, the language "in §1.1502–32(b)(3)(iii)(B), and will effect P's" is corrected to read "in §1.1502–32(b)(3)(iii)(B), and will affect P's".

§1.1502–32 [Corrected]

26. On page 2991, column 3, §1.1502–32(b)(3)(iii)(C), line 3 from bottom of the paragraph, the language "**Federal Register**, see 1.1502–" is corrected to read "**Federal Register**, see §1.1502–".

27. On page 2991, column 3, §1.1502–32(b)(3)(iii)(D), line 3 from bottom of the paragraph, the language "see 1.1502–32(b)(3)(iii)(D) as contained" is corrected to read "see §1.1502–32(b)(3)(iii)(D) as contained".

28. On page 2991, column 3, §1.1502–32(c)(1)(i), line 2 from bottom of the column, the language "allocated to the shares of S's stock to" is corrected to read "allocated to the shares of S stock to".

29. On page 2993, column 1, §1.1502–32(c)(1)(ii)(A)(*2*) *Example*.(iv)(D), line7 from bottom of the column, the language "nondeductible basis recovery item if it is" is corrected to read "nondeductible basis recovery item if it were".

30. On page 2994, column 1, §1.1502–32(c)(2)(i), line 11, the language "that member's excess loss accounts and" is corrected to read "that member's excess loss account and".

31. On page 2994, column 2, §1.1502–32(c)(4)(i), line 3 of the paragraph, the language "share of S's preferred and common stock" is corrected to read "share of S preferred and common stock".

32. On page 2994, column 2, §1.1502–32(c)(4)(i), line 8 of the paragraph, the language "made by reallocating S's adjustments" is corrected to read "made by reallocating S stock adjustments".

33. On page 2994, column 2, §1.1502–32(c)(4)(i), last line of the paragraph, the language "of S's shares. * * *" is corrected to read "of the S shares. * * *".

§1.1502–35 [Corrected]

34. On page 2994, column 3, §1.1502–35(a), line 5 from bottom of the paragraph, the language "of April 1, 2006. For transfers and" is corrected to read "of April 1, 2007. For transfers and".

35. On page 2995, column 1, §1.1502–35(b)(3)(iii), line 4, the language "year of the group) is a noncapital," is corrected to read "year of the selling group) is a noncapital,".

§1.1502–36 [Corrected]

36. On page 2995, column 2, the language of the section heading "§1.1502–36 Loss on subsidiary stock." is corrected to read "§1.1502–36 Unified rule for loss on subsidiary stock.".

37. On page 2996, column 2, §1.1502–36(b)(1)(i), line 4 of the paragraph, the language "(b) reduce the extent to which there is" is corrected to read "(b) reduce (but do not increase) the extent to which there is".

38. On page 2997, column 1, §1.1502–36(b)(2)(iii)(A), line 2 of the paragraph, the language "Reallocations are made in a manner that" is corrected to read "All reallocations (both to and from members' shares of S stock) are made in a manner that".

39. On page 2997, column 2, §1.1502–36(b)(2)(iii)(B)(*2*)(*ii*) *Example*.(*iii*), line 6 from the bottom of the column, the language "would have tiered up to the M share P sold," is corrected to read "would have tiered up to the M share that P sold,".

40. On page 2999, column 2, §1.1502–36(b)(3) *Example 3*.(i), line 5 of the paragraph, the language "preferred shares to reflect their entitlement to" is corrected to read "preferred shares to reflect its entitlement to".

41. On page 2999, column 3, §1.1502–36(b)(3) *Example 3*.(ii)(C), line 8 of the paragraph, the language "Accordingly $25 of that amount is reallocated" is corrected to read " Accordingly, $25 of that amount is reallocated".

42. On page 3000, column 2, §1.1502–36(c)(6)(i), line 5 from the bot-

tom of the paragraph, the language "S1's investment adjustments increased" is corrected to read "S1's investment adjustments increase".

43. On page 3000, column 3, §1.1502–36(c)(6)(v) *Example*.(*ii*), line 3 from the bottom of the paragraph, the language "the loss share stock of S1, the lowest-tier" is corrected to read "the loss share of S1 stock, the lowest-tier".

44. On page 3000, column 3, §1.1502–36(c)(6)(v) *Example*.(*iii*), line 3 from the bottom of the paragraph, the language "recognized on the transfer of S3 tiers up to" is corrected to read "recognized on the transfer of S3 stock tiers up to".

45. On page 3001, column 3, §1.1502–36(c)(8) *Example 1*.(*i*)(C), line 13 of the paragraph, the language "recognized on the sale of Asset 1. Thus the" is corrected to read "recognized on the sale of Asset 1. Thus, the".

46. On page 3001, column 3, §1.1502–36(c)(8) *Example 1*.(*ii*), line 5 from the bottom of the paragraph, the language "Asset 1 to $0) Because the net positive" is corrected to read "Asset 1 to $0). Because the net positive".

47. On page 3002, column 3, §1.1502–36(c)(8) *Example 1*.(*iv*)(B), line 4 of the paragraph, the language "there redetermination would change no" is corrected to read "redetermination would change no".

48. On page 3003, column 2, §1.1502–36(c)(8) *Example 4*.(*ii*), lines 4 through 10 of the column, the language "Because the net positive adjustment includes items of income (and not just gain), the analysis of the application of this paragraph (c) is the same here as in paragraph (i)(C) of this *Example 4*. Furthermore, the analysis of the application of this paragraph (C) would also be the same if the $60 loss carryover were subject to a section 382 limitation from a prior ownership change, and if, instead, it would subject to the limitation in §1.1502–" is corrected to read "The analysis of the application of this paragraph (c) is the same here as in paragraph (i)(C) of this *Example 4*. Furthermore, the analysis of the application of this paragraph (c) would also be the same if the $60 loss carryover were subject to a section 382 limitation from a prior ownership change, if, instead, it were subject to the limitation in §1.1502–".

49. On page 3003, column 2, §1.1502–36(c)(8) *Example 5*.(*i*), lines 7 through 10 of the paragraph, the language "December 31, year 1, P sells one of its shares, Share 1, for $20. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in its Share" is corrected to read "December 31, year 1, P sells one of its S shares, Share 1, for $20. After applying and giving effect to all generally applicable rules of law (other than this section), P's basis in Share".

50. On page 3003, column 2, §1.1502–36(c)(8) *Example 5*.(*iii*), line 6 from the bottom of the paragraph, the language "($100 from the sale of the asset), and Share" is corrected to read "($100 from the sale of Asset), and Share".

51. On page 3004, column 3, §1.1502–36(c)(8) *Example 7*.(*i*), line 8 from the bottom of the paragraph, the language "basis in S1 under §1.1502–32 by $40 (to" is corrected to read "basis in the S1 share under §1.1502–32 by $40 (to".

52. On page 3006, column 2, §1.1502–36(d)(5)(ii)(B)(*3*), line 3 from the bottom of the paragraph, the language "extent necessary to reduce the bases of" is corrected to read "extent necessary to reduce the basis of".

53. On page 3006, column 2, §1.1502–36(d)(5)(ii)(B)(*4*), line 2 from the bottom of the paragraph, the language "the basis of such shares without" is corrected to read "the bases of such shares without".

54. On page 3007, column 1, §1.1502–36(d)(6)(ii)(B), line 5 from the bottom of the paragraph, the language "immediately tier up (under the" is corrected to read "immediately tiers up (under the".

55. On page 3007, column 3, §1.1502–36(d)(6)(iv), line 4 of the paragraph, the language "all members' basis in loss shares of S" is corrected to read "all members' bases in loss shares of S".

56. On page 3007, column 3, §1.1502–36(d)(7) *Example 1*.(*i*)(B), line 3 of the paragraph, the language "under paragraph (b) of this section either" is corrected to read "under paragraph (b) of this section because".

57. On page 3008, column 1, §1.1502–36(d)(7) *Example 1*.(*i*)(B), line 2 of the column, the language "disparity in the basis of the shares). See" is corrected to read "disparity in the bases of the shares). See".

58. On page 3009, column 2, §1.1502–36(d)(7) *Example 4*.(*i*)(A), line 4 of the column, the language "the $500 income earned). The sale is" is corrected to read "the $500 of income earned). The sale is".

59. On page 3010, column 2, §1.1502–36(d)(7) *Example 5*.(*i*)(C)(*3*), line 10 from the bottom of the paragraph, the language "the transaction ($50) over the sum of" is corrected to read "the transaction ($50) over the sum of the".

60. On page 3010, column 3, §1.1502–36(d)(7) *Example 5*.(*ii*)(C)(*4*), lines 15 to 21 of the paragraph, the language "reductions to share A and to share B under this paragraph (d) are reversed to restore the basis of each share to $12.50. Thus, $25 of the $27.50 attribute reduction applied to reduce the basis of share A and $25 of the $47.50 attribute reduction applied to reduce the basis of share B are reversed, restoring the" is corrected to read "reductions to Share A and to Share B under this paragraph (d) are reversed to restore the basis of each share to $12.50. Thus, $25 of the $27.50 attribute reduction applied to reduce the basis of Share A and $25 of the $47.50 attribute reduction applied to reduce the basis of Share B are reversed, restoring the".

61. On page 3011, column 2, §1.1502–36(d)(7) *Example 6*.(*ii*)(B), line 2 from the bottom of the column, the language "basis in subsidiary stock under the principles" is corrected to read "bases in subsidiary stock under the principles".

62. On page 3011, column 3, §1.1502–36(d)(7) *Example 6*.(*ii*)(B), line 2 from the top of the column, the language "the transaction the sale is not subject to" is corrected to read "the transaction, the sale is not subject to".

63. On page 3011, column 3, §1.1502–36(d)(7) *Example 6*.(*ii*)(C), line 3 of the paragraph, the language "*this section*). The next highest tier transfer is" is corrected to read "*this section*). The next higher tier transfer is".

64. On page 3011, column 3, §1.1502–36(d)(7) *Example 6*.(*ii*)(C), line 8 from the bottom of the paragraph, the language "of the transferred Share E minus the $20" is corrected to read "of the transferred share E minus the $20".

65. On page 3011, column 3, §1.1502–36(d)(7) *Example 6*.(*ii*)(D)(*1*), line 6 from the bottom of the paragraph, the language "basis in its asset)) minus S's liability ($20)." is corrected to read "basis in its asset))) minus S's liability ($20).".

66. On page 3011, column 3, §1.1502–36(d)(7) *Example 6*.(*ii*)(D)(*2*), lines 5 to 6 from the bottom of the paragraph, the language "applied to reduce the basis of share E because share E was transferred in a transaction in" is corrected to read "applied to reduce the basis of share E, because share E was transferred in a transfer in".

67. On page 3011, column 3, §1.1502–36(d)(7) *Example 6*.(*ii*)(D)(*3*), line 3 from the bottom of the column, the language "apportioned to or applied to reduced the" is corrected to read "apportioned to or applied to reduce the".

68. On page 3012, column 3, §1.1502–36(d)(7) *Example 7*.(*iii*)(C)(*3*), line 16 of the paragraph, the language "reducing the basis of both assets to $0." is corrected to read "reducing the basis of each asset to $0.".

69. On page 3012, column 3, §1.1502–36(d)(7) *Example 7*.(*iii*)(C)(*3*), line 2 from the bottom of the paragraph, the language "attribute reduction amount is disregarded has" is corrected to read "attribute reduction amount is disregarded and has".

70. On page 3013, column 1, §1.1502–36(d)(7) *Example 8*.(*i*)(E), line 5 of the paragraph, the language "basis in the S shares by the full attribute" is corrected to read "bases in the S shares by the full attribute".

71. On page 3013, column 2, §1.1502–36(d)(7) *Example 8*.(*i*)(E), line 7 of the paragraph, the language "transfer. The reduction of M's basis in the S" is corrected to read "transfer. The reduction of M's bases in the S".

72. On page 3014, column 1, §1.1502–36(d)(7) *Example 8*.(*ii*)(E), lines 2 through 5 of the paragraph, the language "are the same as paragraph (ii)(A) of this *Example 8*, except that P elects under paragraph (d)(6) of this section to reduce M's basis in the S shares by the full attribute" is corrected to read "are the same as in paragraph (ii)(A) of this *Example 8*, except that P elects under paragraph (d)(6) of this section to reduce M's bases in the S shares by the full attribute".

73. On page 3014, column 1, §1.1502–36(d)(7) *Example 8*.(*ii*)(F), is removed.

74. On page 3014, column 1, §1.1502–36(d)(7) *Example 8*.(*ii*)(G), is the newly designated paragraph (F).

75. On page 3014, column 2, §1.1502–36(d)(7) *Example 9*.(*i*), line 5 from the bottom of the column, the language "to P1 (the common parent of a consolidated" is corrected to read "to P1 (the common parent of a different consolidated".

76. On page 3014, column 3, §1.1502–36(d)(7) *Example 9*.(*ii*), line 7 from the bottom of the column, the language "computed and is applied to adjust the basis" is corrected to read "computed and is applied to adjust the bases".

77. On page 3015, column 1, §1.1502–36(d)(7) *Example 9*.(*iii*), line 1 of the paragraph, the language "(iii) *Transfers in next highest tier (loss*" is corrected to read "(iii) *Transfers in next higher tier (loss*".

78. On page 3015, column 3, §1.1502–36(d)(7) *Example 9*.(*iv*)(B)(*2*), line 30 from the bottom of the paragraph, the language "allocated amount is apportioned among other" is corrected to read "allocated amount is apportioned among the other".

79. On page 3017, column 1, §1.1502–36(e)(1), last line of the paragraph, the language "the section." is corrected to read "this section.".

80. On page 3017, column 2, §1.1502–36(e)(2)(iii), line 6 of the paragraph, the language "allocable portion of S's attributes has" is corrected to read "allocable portion of S's net inside attributes has".

81. On page 3017, column 2, §1.1502–36(e)(2)(iv) *Example*.(*i*)(A), line 11 of the paragraph, the language "basis of A1 would have been reduced by $80" is corrected to read "basis in Asset 1 would have been reduced by $80".

82. On page 3017, column 2, §1.1502–36(e)(2)(iv) *Example*.(*i*)(B), last line of the paragraph, the language "to this paragraph (c)." is corrected to read "to paragraph (c) of this section.".

83. On page 3018, column 1, §1.1502–36(f)(2), line 6 of the column, the language "dealers in securities) and 481" is corrected to read "dealers in securities) and section 481".

84. On page 3018, column 1, §1.1502–36(f)(4), lines 6 through 15 of the paragraph, the language "basis of shares of S2 stock under §1.1502–32 affect the investment adjustments made to the basis of the stock of S1. A subsidiary (S1) (and its shares of stock) is *lower tier* with respect to another subsidiary (S) (and its shares of stock) if investment adjustments made to the basis of shares of S1 stock affect the investment adjustments made to the basis of shares of S stock. The" is corrected to read "bases of shares of S2 stock under §1.1502–32 affect the investment adjustments made to the bases of shares of S1 stock. A subsidiary (S1) (and its shares of stock) is *lower tier* with respect to another subsidiary (S) (and its shares of stock) if investment adjustments made to the bases of shares of S1 stock affect the investment adjustments made to the bases of shares of S stock. The".

85. On page 3019, column 1, §1.1502–36(g)(2) *Example 3*.(*ii*), line 4 of the paragraph, the language "there is no disparity in the basis of the" is corrected to read "there is no disparity in the bases of the".

86. On page 3019, column 1, §1.1502–36(g)(2) *Example 4*.(*i*), lines 5 through 6 from the bottom of the paragraph, the language "equal basis that exceeds value. S owns Asset 1 with a basis that exceeds value and cash." is corrected to read "equal basis that exceeds value. S owns Cash and Asset 1 with a basis that exceeds value.".

87. On page 3019, column 1, §1.1502–36(g)(2) *Example 4*.(*ii*), line 4 of the paragraph, the language "there is no disparity in the basis of the" is corrected to read "there is no disparity in the bases of the".

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(Filed by the Office of the Federal Register on June 6, 2007, 8:45 a.m., and published in the issue of the Federal Register for June 7, 2007, 8:45 a.m., 72 F.R. 31483)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
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