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Department of the Treasury

PRESS RELEASES

The following numbers were not used:

JS-1054, 1058 AND 1072

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 2, 2003
JS-1029

Secretary John W. Snow Meets with House Financial Services Committee Chairman Michael G. Oxley to Discuss Issues Related to Financial Services and the Economy

Media Contact
All media queries should be directed to
The Press Office at (202) 622-2960.
Only call this number if you are a member of the media.

High Resolution Image

FROM THE OFFICE OF PUBLIC AFFAIRS

December 2, 2003
2003-12-2-16-55-25-9842

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $85,156 million as of the end of that week, compared to $84,993 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*

	November 21, 2003			November 28, 2003		
TOTAL		84,993			85,156	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	7,949	14,448	22,397	7,988	14,361	22,349
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	12,989	2,902	15,891	13,083	2,885	15,968
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			23,586			23,675
3. Special Drawing Rights (SDRs) [2]			12,076			12,121
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	November 21, 2003			November 28, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						

	November 21, 2003			November 28, 2003		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	November 21, 2003			November 28, 2003		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions Headquartered in the U.S.						
3.c. With banks and other financial institutions Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be subject to revision. IMF data for the prior week are final.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

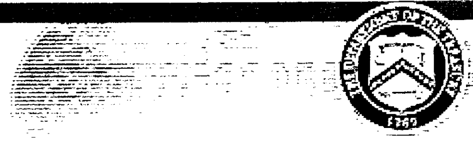
FROM THE OFFICE OF PUBLIC AFFAIRS

December 3, 2003
JS-1030

Statement by Secretary John Snow on the SEC's Mutual Fund Reform Proposals

Mutual funds are vitally important savings tools for millions of American families. They play an essential role in business growth and job creation and have helped transform America into an ownership society. The thoughtful reform proposals put forth by Chairman Donaldson today as part of his Mutual Fund Investors' Rights Agenda represent important progress in strengthening the governance and transparency of mutual funds, in preserving the critical role that these funds play in our financial system, and in protecting investors.

I look forward to working with Chairman Donaldson as the SEC continues to pursue reforms to ensure that our nation's financial markets remain strong, fair and accessible for all Americans. This administration will not tolerate wrongdoing by anyone who would abuse the trust of investors. I am pleased by the action the SEC took today, and I am confident Chairman Donaldson will continue to seek out bad actors and bring them to justice.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 3, 2003
js-1031

Remarks of
Michael A. Dawson
Deputy Assistant Secretary
for
Critical Infrastructure Protection and Compliance Policy
at the Fourth E-Gov Homeland Security Conference
Washington, D.C.

Thank you for this opportunity to address the economic risks associated with terrorism.

This is an issue that is very important to the Department of the Treasury. At the Treasury, we are responsible for developing and promoting policies that create jobs and improve the economy. We are equally concerned with developing and promoting policies that enhance the resiliency of the economy, policies that minimize the economic damage and speed economic recovery from a terrorist attack. In addition to these general responsibilities, the President has named Treasury as the lead agency to enhance the resiliency of the critical financial infrastructure.

These two responsibilities are closely related. As Secretary Snow has said, the financial system is the engine of our economy. In a very real sense, the resilience of the American economy depends on the resilience of the American financial system.

Fortunately, we are starting from a very strong base. The American economy is remarkably resilient. Over the past few years, we have seen that resilience first hand, as the American economy withstood a significant fall in equity prices, a recession, the terrorist attacks of September 11, a rash of corporate governance scandals, and power outage of August 14-15. There are many reasons for the resilience of the American economy. Good policies have played an important part. So has the resilience of the American people. One of the reasons we are so strong is that our people are so tough, so determined to protect our way of life.

Like the economy as a whole, the American financial system is remarkably resilient. During the power outage in August that affected cities from Cleveland to New York City, for example, the financial system performed extraordinarily well. With one exception, the bond and major equities and futures markets were open the next day at their regular trading hours. Major market participants were well prepared, having invested in contingency plans, procedures, and equipment such as backup power generators. This resilience mitigates the economic risks of terrorist attacks, both to the financial system itself and to the American economy as a whole.

Although we are starting from a strong base, the fact remains that we are still exposed to significant risks of economic disruption from terrorist attacks. Four principles guide our efforts to manage these risks. These principles guided our decisions as the financial system recovered from the attacks of September 11th. They guide our actions still.

The first principle is to remember that the financial system is really about people. People, not buildings or computers, produce financial services. And it is people who benefit from financial services.

We depend on people to run the financial system. We need these people – tellers, technicians, loan officers, technicians, technologists – to see the system through times of stress. Indeed, it was the commitment of these professionals to their institutions, customers, and colleagues that helped the financial system recover from the attacks of September 11th and weather the power outage of August 14-15.

Just as we depend on people to run the financial system, people depend on the financial system to run. Virtually every American depends on financial services to get their paycheck, buy their groceries, purchase a house, finance their children's education, or save for retirement. We must ensure that people continue to have confidence that the financial system will meet their needs.

The second principle is the importance of maintaining confidence. Confidence in the ability of financial institutions to clear checks, execute transactions, and satisfy insurance obligations helps the system weather significant disruption from evolving threats. By relying on a sound financial system, Americans can make business decisions for the future and conduct necessary business in the present.

The third principle is to ensure that the financial system remains accessible and open for business when the safety of the employees permits. During times of disaster, investors depend on markets to price the impact of the disruption on assets. The longer markets are closed, the longer investors must go without knowing what the impact will be. This uncertainty can itself be harmful to the economy, compounding the impact of any disruption. The sooner we can eliminate this uncertainty, the more we can mitigate the impact and speed recovery.

Fourth, we want to promote responsible decision-making and problem-solving within the private sector. Financial institutions should make the appropriate decisions without waiting for guidance from Washington. After all, it is the private sector that owns and operates the majority of the financial systems. And it is the private sector that best knows how to help these systems recover from a disruption. We will help when needed, but we intend for the private sector to find the necessary solutions.

These are the principles that guide our actions in managing the risks of terrorism to our financial system. But what are our actions? Let me highlight just three.

First, we have helped to develop a next generation Financial Services Information Sharing and Analysis Center (FS/ISAC). Since 1999, the FS/ISAC has been a leader in information sharing for the financial sector, allowing members to receive and submit anonymous reports on security threats and solutions. The FS/ISAC, however, has been limited in scope. It focused primarily on cyber threats. And it served only 56 financial institutions, albeit 56 of the biggest ones. In addition, Congress has expressed concern over the technological capabilities of the FS/ISAC. Shortly, Treasury will help launch a new and improved FS/ISAC. This next generation FS/ISAC will include both cyber and physical threat information; serve the entire sector, not just 56 large institutions; and deploy a secure, confidential technology platform where companies can exchange information in real time as they identify vulnerabilities, address the vulnerabilities, and respond to attempts to exploit the vulnerabilities.

Second, we have recently reached an agreement with Assistant Secretary Patrick Hughes of the Department of Homeland Security to detail an expert in financial services issues to the Information Analysis directorate of the Homeland Security Department. Initially, this person will be a Department of the Treasury employee. Over time, however, we will rotate other employees from other financial regulators through the Department. In so doing, we will ensure that financial services issues and perspectives are considered early in the process of evaluating information about terrorist threats. The resulting product will help federal, state, and local authorities better protect our financial infrastructure. As important, when we are able to share that information with the private sector, it will help the owners and operators of that infrastructure better manage risks.

Third, we have developed proven procedures for secure communications between federal and state financial regulators. During times of crisis, these communications procedures help financial regulators share information about the impact of an event on the financial institutions regulated by that regulator. By pooling information about the impact of a disruption, we can together form a quick, accurate assessment of the overall impact of an event on the financial sector as a whole.

This information helps guide our action as regulators. But, more importantly, we can share the information with financial institutions and help them better weather the disruption. This system worked in real time during the power outage of August 14-15 and its results were summarized in a report to Congress in October of 2003. (The report is available at http://www.treas.gov/offices/domestic-finance/financial-institution/cip/pdf/impact.pdf)

These are but three of our recent actions. They highlight the importance we place on developing accurate and timely information about threats and sharing that information with the private sector. As more and better information about the threats they face becomes available, the people in the private sector who own and operate our financial infrastructure can better estimate the risks they bear. Furthermore, they can better invest to reduce the probability of a threat against their infrastructure, thereby lessening the consequences that a disruption might pose.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 4, 2003
js-1032

Remarks of
Michael A. Dawson
Deputy Assistant Secretary
For Critical Infrastructure Protection and Compliance Policy
at the
Conference on Critical Financial Infrastructure Protection
Organized by the Federal Deposit Insurance Corporation
Charlotte, North Carolina

I am here in North Carolina today to talk about what we are doing in Washington to help you protect the critical financial infrastructure. I don't have to tell anyone in North Carolina that the critical financial infrastructure exists outside of Washington. North Carolina is an important center of financial innovation. Institutions like the Bank of America, Wachovia, BB&T, and the Latino Community Credit Union all attest to North Carolina's strong tradition of financial innovation and leadership.

In partnership with the FDIC, the Department of the Treasury and our colleagues in the public and private sectors are speaking to audiences in twenty-four cities across the United States. After our eighteen month tour, we will have spoken to 6,000 individuals; on average, 250 people per city. Through this outreach, we hope to encourage you – stewards of financial services in North Carolina – to take advantage of policies and programs that will further strengthen the U.S. critical financial infrastructure.

This is an issue that is very important to the Department of the Treasury. At the Treasury, we are responsible for developing and promoting policies that create jobs and improve the economy. We are equally concerned with developing and promoting policies that enhance the resiliency of the economy, policies that minimize the economic damage and speed economic recovery from a terrorist attack. In addition to these general responsibilities, the President has named Treasury as the lead agency to enhance the resiliency of the critical financial infrastructure.

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terrorist attacks, both to the financial system itself and to the American economy as a whole.

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The first principle is to remember that the financial system is really about people. People, not buildings or computers, produce financial services. And it is people who benefit from financial services.

We depend on people to run the financial system. We need these people -- tellers, technicians, loan officers, technicians, technologists -- to see the system through times of stress. Indeed, it was the commitment of these professionals to their institutions, customers, and colleagues that helped the financial system recover from the attacks of September 11th and weather the power outage of August 14-15.

Just as we depend on people to run the financial system, people depend on the financial system to run. Virtually every American depends on financial services to get their paycheck, buy their groceries, purchase a house, finance their children's education, or save for retirement. We must ensure that people continue to have confidence that the financial system will meet their needs.

The second principle is the importance of maintaining confidence. Confidence in the ability of financial institutions to clear checks, execute transactions, and satisfy insurance obligations helps the system weather significant disruption from evolving threats. By relying on a sound financial system, Americans can make business decisions for the future and conduct necessary business in the present.

The third principle is to ensure that the financial system remains accessible and open for business when the safety of the employees permits. During times of disaster, investors depend on markets to price the impact of the disruption on assets. The longer markets are closed, the longer investors must go without knowing what the impact will be. This uncertainty can itself be harmful to the economy, compounding the impact of any disruption. The sooner we can eliminate this uncertainty, the more we can mitigate the impact and speed recovery.

Fourth, we want to promote responsible decision-making and problem-solving within the private sector. Financial institutions should make the appropriate decisions without waiting for guidance from Washington. After all, it is the private sector that owns and operates the majority of the financial systems. And it is the private sector that best knows how to help these systems recover from a disruption. We will help when needed, but we intend for the private sector to find the necessary solutions.
With these principles in mind, we have organized ourselves into two main groups. One is the Financial and Banking Information Infrastructure Committee (FBIIC). The FBIIC is sponsored by the President's Working Group on Financial Markets and consists of many state and federal regulators. The FDIC, which organized this conference today, is a member. So too are the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the National Association of Insurance Commissioners, the Conference of State Banking Supervisors, and many other important regulators. Treasury chairs the FBIIC.

Another important group is the Financial Services Sector Coordinating Council (FSSCC). The FSSCC consists of virtually every important financial services association. The FSSCC is coordinated by Rhonda MacLean, an executive based here in Charlotte with Bank of America. Treasury was pleased to appoint Rhonda to this position. She has done an outstanding job.

Together, the FBIIC and the FSSCC work to systematically identify the critical financial infrastructure, identify vulnerabilities in that infrastructure, address the vulnerabilities, and evaluate our progress.

These are the principles and structures that guide our actions in managing the risks of terrorism to our financial system. But what are our actions? What are we doing

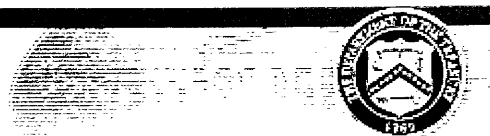
that will help you manage the risks you face? Let me highlight just three. You will learn more about these – and other opportunities – during the course of the day from other speakers.

First, we have helped to develop a next generation Financial Services Information Sharing and Analysis Center (FS/ISAC). Since 1999, the FS/ISAC has been a leader in information sharing for the financial sector, allowing members to receive and submit anonymous reports on security threats and solutions. The FS/ISAC, however, has been limited in scope. It focused primarily on cyber threats. And it served only 56 financial institutions, albeit 56 of the biggest ones. In addition, Congress has expressed concern over the technological capabilities of the FS/ISAC. Shortly, Treasury will help launch a new and improved FS/ISAC. This next generation FS/ISAC will include both cyber and physical threat information; serve the entire sector, not just 56 large institutions; and deploy a secure, confidential technology platform where companies can exchange information in real time as they identify vulnerabilities, address the vulnerabilities, and respond to attempts to exploit the vulnerabilities. You can learn more about how your financial institution can benefit from the FS/ISAC at www.fsisac.com.
Second, we have recently reached an agreement with Assistant Secretary Patrick Hughes of the Department of Homeland Security to detail an expert in financial services issues to the Information Analysis directorate of the Homeland Security Department. Initially, this person will be a Department of the Treasury employee. Over time, however, we will rotate other employees from other financial regulators through the Department. In so doing, we will ensure that financial services issues and perspectives are considered early in the process of evaluating information about terrorist threats. The resulting product will help federal, state, and local authorities better protect our financial infrastructure. As important, when we are able to share that information with the private sector, it will help the owners and operators of that infrastructure better manage risks.

Third, we have developed proven procedures for secure communications between federal and state financial regulators. During times of crisis, these communications procedures help financial regulators share information about the impact of an event on the financial institutions regulated by that regulator. By pooling information about the impact of a disruption, we can together form a quick, accurate assessment of the overall impact of an event on the financial sector as a whole. This information helps guide our action as regulators. But, more importantly, we can share the information with financial institutions and help them better weather the disruption. This system worked in real time during the power outage of August 14-15 and its results were summarized in a report to Congress in October of 2003. (The report is available at http://www.treas.gov/offices/domestic-finance/financial-institution/cip/pdf/impact.pdf)

These are but three of our recent actions. They highlight the importance we place on developing accurate and timely information about threats and sharing that information with the private sector. As more and better information about the threats they face becomes available, the people in the private sector who own and operate our financial infrastructure can better estimate the risks they bear. Furthermore, they can better invest to reduce the probability of a threat against their infrastructure, thereby lessening the consequences that a disruption might pose.

Thank you for your time today. Thank you for attending this important conference.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 4, 2003
JS-1033

MEDIA ADVISORY
Secretary John Snow to Discuss U.S. Economy
in St. Louis, Missouri on Friday

Treasury Secretary John W. Snow will visit St. Louis, Missouri on Friday, December 5th to discuss the state of the economy, as well as efforts by President Bush to create jobs, strengthen the economic recovery and increase workers' standards of living.

In St. Louis, Secretary Snow will tour a construction site, meet with local construction industry leaders, and tour a vocational school that is teaching students job skills. The construction industry, an important segment of the overall U.S. economy, is showing signs of improvement. The Commerce Department this week reported that construction spending increased 0.9 percent in October, to a record $922 billion annual rate.

According to a leading trade group, the construction industry employs nearly 7 million people or about six percent of the nation's non-farm, private sector employment, with an annual payroll of $250 billion. The construction industry also contributes nearly eight percent of the Gross Domestic Product (GDP) as measured by the value of construction put in place.
The following events are open to the media:

10:30 am CST Tour of Metroloft Apartment construction site
4555 Forest Park Blvd.
St. Louis, MO
** PHOTO OP ONLY - NO REMARKS BY THE SECRETARY

1:00 pm CST Tour of Construction Careers Center charter school
1224 Gratton
St. Louis, MO
** AT THE END OF THE TOUR, THE SECRETARY WILL CONDUCT A SHORT PRESS AVAILABILITY

JS-1033

Impact of the President's Jobs and Growth Package on Missouri

The package provides benefits to more than 1.7 million Missouri taxpayers.

REDUCING TAXES
• More than 1.7 million taxpayers in Missouri have lower income tax bills in 2003.
• Nearly 390,000 business taxpayers can use their tax savings to invest in new equipment, hire additional workers, and increase pay.

ACCELERATE 10-PERCENT BRACKET EXPANSION
• More than 1.3 million married couples and single filers benefit from the acceleration to 2003 of the expansion of the 10-percent bracket scheduled for 2008.

ACCELERATE REDUCTION IN INCOME TAX RATES
• Nearly 440,000 taxpayers in Missouri benefit from the acceleration to 2003 of the reductions in income tax rates in excess of 15-percent scheduled for 2004 and 2006.

ACCELERATE REDUCTION IN MARRIAGE PENALTY

• 715,000 married couples in Missouri benefit from the acceleration to 2003 of provisions that increase the standard deduction for joint filers to double the amount for single filers and increase the width of the 15-percent bracket to twice the width for single filers. These two provisions are scheduled to phase in between 2005 and 2009.

ACCELERATE INCREASE IN CHILD TAX CREDIT

• More than 510,000 married couples and single parents in Missouri benefit from the acceleration to 2003 of the increase in the child tax credit from $600 to $1,000 that is scheduled to phase in between 2005 and 2010.

EXCLUSION FOR CORPORATE DIVIDENDS

• 470,000 taxpayers in Missouri benefit from the reduced tax rates on capital gains and dividends.

PRLSS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 4, 2003
JS-1034

Treasury and IRS Shut Down Abusive Tax Avoidance Transaction Involving Options on Foreign Currencies

Today the Treasury Department and the Internal Revenue Service issued guidance to bar transactions in which taxpayers dispose of a pair of offsetting options, claiming a loss on one of the options but contending that they never have to recognize the corresponding gain on the other. These transactions are now "listed transactions." Taxpayers who have entered into these transactions must disclose them to the IRS, and advisors promoting their use will be required to maintain lists of participating taxpayers.

"This is another step in our ongoing efforts to stop abusive tax avoidance transactions," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "We have given taxpayers notice that if they assign an option in one of these transactions they must recognize the gain. If they fail to do so, they will have to disclose their transaction to the IRS."

"We are seeing increasingly creative and complex deals involving foreign currencies and charities that are designed to abuse the tax code," IRS Commissioner Mark W. Everson said. "Today's guidance closes the door on this transaction. We are continuing to use all the tools at our disposal to combat potentially abusive transactions."

These transactions involve two pairs of offsetting options on foreign currencies that, collectively, are structured to have little real risk of economic gain or loss. The taxpayer assigns two offsetting options to a charity, claiming an immediate loss on one of the options and taking the position that it does not have to take into account the offsetting gain in the other assigned option. The taxpayer disposes of the remaining pair of offsetting options. The result is a large tax benefit (the claimed tax loss on one assigned option) without recognition of the matching economic gain on the other assigned option.

The Treasury Department and the Internal Revenue Service believe that the promoters and taxpayers involved in these transactions are misapplying the rules relating to the inclusion of gain on the assigned option in taxable income. The Internal Revenue Service will challenge the tax benefits claimed by taxpayers who have entered into these transactions.

Related Documents:

- The Text of Notice 2003-81

Part III - Administrative, Procedural and Miscellaneous

Tax Avoidance Using Offsetting Foreign Currency Option Contracts

Notice 2003-81

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, in which a taxpayer claims a loss upon the assignment of a section 1256 contract to a charity but fails to report the recognition of gain when the taxpayer's obligation under an offsetting non-section 1256 contract terminates. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and those that are substantially similar to these transactions, 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. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

A taxpayer pays premiums to purchase a call option and a put option (the purchased options) on a foreign currency. 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 section 1256(g)(2)(A) of the Internal Revenue Code and section 1256 contracts within the meaning of section 1256(b). 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 section 1256 contracts. 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. Thus, the written options are not foreign currency contracts within the meaning of section 1256(g)(2)(A), nor are they section 1256 contracts within the meaning of section 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 non-section 1256 contracts.

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. 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 purchased option assigned to the charity is a section 1256 contract, the taxpayer relies on section 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 assumed written option is not a section 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

Rev. Rul. 58-234, 1958-1 C.B. 279, clarified by Rev. Rul. 68-151, 1968-1 C.B. 363, holds that an option writer does not recognize income or gain with respect to a premium received for writing an option until the option is terminated, without exercise, or otherwise. Accord Rev. Rul. 78-182, 1978-1 C.B. 265; Koch v. Commissioner, 67 T.C. 71 (1976), acq. 1980-2 C.B. 1. Rev. Rul. 58-234 explains that this is the treatment for the option writer because the option writer assumes a burdensome and continuing obligation, and the transaction therefore stays open without any ascertainable income or gain until the writer's obligation is finally terminated. When the option writer's obligation terminates, the transaction closes, and the option writer must recognize any income or gain attributable to the prior receipt of the option premium.

In some cases, the option writer's obligation under the option contract may terminate on the charity's assumption of the written option obligation. In other cases, the writer will have a continuing obligation because the writer may be called upon to perform if the charity fails to perform or to reimburse the charity for any losses or expenses it may incur if called upon to perform. If an assumption terminates the option writer's obligation under the option contract, the option writer must recognize gain when the option obligation is assumed. If the assumption does not terminate the option writer's obligation under the option contract, the option writer must recognize the premium when the option writer's obligation under the option contract terminates (other than through an exercise of the option against, and performance by, the option writer).

These general principles remain applicable even if the assumption of the option writer's obligation is part of what the taxpayer claims is a donative transaction. Cf. Diedrich v. Commissioner, 457 U.S. 191 (1982) (noting that if a donee pays a gift tax obligation arising from a donative transfer, the donative nature of the transaction does not preclude income recognition by the donor on the obligation assumed). Here, the taxpayer has made a transfer to the charity of the purchased option, and the charity has assumed the burden of the written option. No aspect of the taxpayer's transfer or the charity's assumption (or their combination) relieves the taxpayer from its duty under the Code to account for the gain attributable to the premium originally received by the taxpayer for

assuming the burden of writing the option. See Lucas v. Earl, 281 U.S. 111 (1930) (holding that a taxpayer may not avoid inclusion of future earned income by making a gratuitous transfer of the right to receive the income).

Finally, if the taxpayer has any unrecognized gain on the written option at the end of the year in which the assumption occurs (e.g., the assumption did not terminate the option writer's obligation under the option contract), the mark-to-market loss on the offsetting contributed section 1256 contract will be deferred under section 1092.

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective December 4, 2003, the date this notice was released to the public. Variations on these transactions may include positions in other section 1256 and non-section 1256 contracts. Independent of their classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of section 6011 (§ 1.6011-4), the tax shelter registration requirements of section 6111 (§§301.6111-1T, 301.6111-2), or the list maintenance requirements of section 6112 (§ 301.6112-1). Persons who are required to register these tax shelters under section 6111 but have failed to do so may be subject to the penalty under section 6707(a). Persons who are required to maintain lists of investors under section 6112 but have failed to do so (or who fail to provide those lists when requested by the Service) may be subject to the penalty under section 6708(a). In addition, the Service may impose penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

The principal author of this notice is Clay Littlefield of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Mr. Littlefield at (202) 622-3920 (not a toll-free call).

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 4, 2003

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 13-WEEK AND 26-WEEK BILLS

The Treasury will auction 13-week and 26-week Treasury bills totaling $32,000 million to refund an estimated $32,748 million of publicly held 13-week and 26-week Treasury bills maturing December 11, 2003, and to pay down approximately $748 million. Also maturing is an estimated $14,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced December 8, 2003.

The Federal Reserve System holds $14,607 million of the Treasury bills maturing on December 11, 2003, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders either in these auctions or the 4-week Treasury bill auction to be held December 9, 2003. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of each auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

TreasuryDirect customers have requested that we reinvest their maturing holdings of approximately $999 million into the 13-week bill and $603 million into the 26-week bill.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about each of the new securities are given in the attached offering highlights.

oOo

Attachment

JS-1035

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED DECEMBER 11, 2003

December 4, 2003

Offering Amount	$16,000 million	$16,000 million
Maximum Award (35% of Offering Amount)	$ 5,600 million	$ 5,600 million
Maximum Recognized Bid at a Single Rate	$ 5,600 million	$ 5,600 million
NLP Reporting Threshold	$ 5,600 million	$ 5,600 million
NLP Exclusion Amount	$ 5,200 million	None

Description of Offering:

Term and type of security	91-day bill	182-day bill
CUSIP number	912795 PP 0	912795 QC 8
Auction date	December 8, 2003	December 8, 2003
Issue date	December 11, 2003	December 11, 2003
Maturity date	March 11, 2004	June 10, 2004
Original issue date	September 11, 2003	December 11, 2003
Currently outstanding	$20,463 million	---
Minimum bid amount and multiples	$1,000	$1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.

Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:

Noncompetitive tenders..... Prior to 12:00 noon eastern standard time on auction day
Competitive tenders........ Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date, or payment of full par amount with tender. *TreasuryDirect* customers can use the Pay Direct feature, which authorizes a charge to their account of record at their financial institution on issue date.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 1, 2003

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $20,000 million to refund an estimated $17,000 million of publicly held 4-week Treasury bills maturing December 4, 2003, and to raise new cash of approximately $3,000 million.

Tenders for 4-week Treasury bills to be held on the book-entry records of *TreasuryDirect* will not be accepted.

The Federal Reserve System holds $14,832 million of the Treasury bills maturing on December 4, 2003, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders in this auction up to the balance of the amount not awarded in today's 13-week and 26-week Treasury bill auctions. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of the auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about the new security are given in the attached offering highlights.

oOo

Attachment

JS 1036

HIGHLIGHTS OF TREASURY OFFERING OF 4-WEEK BILLS TO BE ISSUED DECEMBER 4, 2003

December 1, 2003

Offering Amount.......................... $20,000 million
Maximum Award (35% of Offering Amount)... $ 7,000 million
Maximum Recognized Bid at a Single Rate.. $ 7,000 million
NLP Reporting Threshold.................. $ 7,000 million
NLP Exclusion Amount..................... $11,800 million

Description of Offering:
Term and type of security...........29-day bill
CUSIP number........................912795 PD 7
Auction date........................December 2, 2003
Issue date..........................December 4, 2003
Maturity date.......................January 2, 2004
Original issue date.................July 3, 2003
Currently outstanding...............$46,307 million
Minimum bid amount and multiples....$1,000

Submission of Bids:
Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.
Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.
Competitive bids:
(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 4.215%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:
Noncompetitive tenders:
Prior to 12:00 noon eastern standard time on auction day
Competitive tenders:
Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date.

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 01, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	December 04, 2003
Maturity Date:	March 04, 2004
CUSIP Number:	912795PN5

High Rate: 0.925% Investment Rate 1/: 0.943% Price: 99.766

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 71.08%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 37,664,022	$ 14,487,864
Noncompetitive	1,297,388	1,297,388
FIMA (noncompetitive)	215,000	215,000
SUBTOTAL	39,176,410	16,000,252 2/
Federal Reserve	5,825,710	5,825,710
TOTAL	$ 45,002,120	$ 21,825,962

Median rate 0.920%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 0.900%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

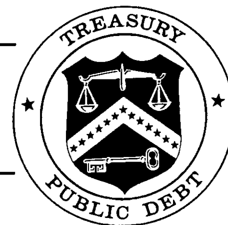
Bid-to-Cover Ratio = 39,176,410 / 16,000,252 = 2.45

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,093,271,000

JS 1037

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239



TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 01, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	December 04, 2003
Maturity Date:	June 03, 2004
CUSIP Number:	912795QB0

High Rate: 1.030% Investment Rate 1/: 1.053% Price: 99.479

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 14.45%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 31,803,855	$ 14,970,655
Noncompetitive	979,402	979,402
FIMA (noncompetitive)	50,000	50,000
SUBTOTAL	32,833,257	16,000,057 2/
Federal Reserve	5,856,191	5,856,191
TOTAL	$ 38,689,448	$ 21,856,248

Median rate 1.020%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.000%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 32,833,257 / 16,000,057 = 2.05

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $799,429,000

JS 1038

Bureau of the Public Debt
United States Department of the Treasury

Public Debt Announces Activity for Securities in the STRIPS Program for November 2003

FOR IMMEDIATE RELEASE

December 4, 2003

The Bureau of the Public Debt announced activity for the month of November 2003, of securities within the Separate Trading of Registered Interest and Principal of Securities program (STRIPS).

	In Thousands
Principal Outstanding (Eligible Securities)	$2,517,442,841
Held in Unstripped Form	$2,342,839,206
Held in Stripped Form	$174,603,635
Reconstituted in November	$11,538,231

The accompanying table, gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. These monthly figures are included in Table V of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form."

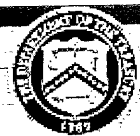
The STRIPS table, along with the new Monthly Statement of the Public Debt, is available on Public Debt's Internet site at: www.publicdebt.treas.gov. A wide range of information about the public debt and Treasury securities is also available at the site.

Intellectual Property | Privacy & Security Notices | Terms & Conditions | Accessibility | Data Quality

U.S. Department of the Treasury, Bureau of the Public Debt

Last Updated September 27, 2004

JS 1040



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 5, 2003
JS-1041

Will Economic Recovery in Japan Be Sustained?
John B. Taylor
Under Secretary of the Treasury for International Affairs
Japan Society
New York
December 5, 2003

Thank you for inviting me to speak here today. The Japan Society is a valuable forum for promoting better understanding and good relations between Japan and the United States. I have benefited from the insights and the activity that the Japan Society has made possible.

America's alliance with Japan is a centerpiece of President Bush's foreign policy. I am happy to say that the alliance is as strong as it has ever been. Japan has been a key player in the war against terrorist financing, one of the most successful international cooperation efforts in the financial area in many years. Japan's generous support for the reconstruction of Afghanistan and Iraq has been invaluable.

We are also grateful for Japan's support in our efforts to raise economic growth around the world. Recently, Japan, the United States, and the other G7 countries agreed on the innovative Agenda for Growth. It is a milestone agreement. Each of the G7 countries identified high priority supply-side reforms to create jobs and raise productivity. Each committed to build on recent reforms by implementing these new measures – and to review progress as part of the regular G7 surveillance process. In the United States, for example, we want to build on the successful tax rate cuts and to implement new policies such as tort reform and saving incentives.

Such reforms are important in all the G7 countries, including the United States. But they are particularly welcome in Japan, because it has struggled economically for more than a decade. Prime Minister Koizumi has embraced structural reforms as the hallmark of his administration.

And things do seem to be changing. The economy has grown for 7 straight quarters, with particularly strong growth this year. The stock market is up 25 percent since the end of March. Banks are reporting increased profits and reductions in bad loans. And there is a rising sense of confidence and optimism among business leaders, officials, and the public.

But many who watch Japan still seem to have a sense of wariness. Previous recoveries—in 1996 and 2000-2001—proved to be short-lived. Is there reason to think that this time is different? That Japan will at last be able to achieve sustained, robust growth?

Fortunately, several factors suggest the current recovery will prove more durable. Perhaps the most important reason for optimism is the new monetary policy the Bank of Japan has put in place. This policy holds the promise of finally eliminating deflation in Japan. For at least 7 years, deflation has been a tremendous drag on the Japanese economy, raising the real value of debts, making the resolution of banking sector problems more difficult, and discouraging consumption and investment. Many factors lead to price changes in the short run, but deflation – a sustained drop in the overall price level – is ultimately a monetary phenomenon.

Economic theory and experience indicates that strong growth in the money supply, maintained over time, is what brings deflation to an end. The Bank of Japan's shift in March 2001 to a policy of sharply raising base money growth—and maintaining

this policy until deflation is eliminated—was therefore a most welcome change. I recall the announcement of this new policy well. It occurred just as I began my current job in the United States government and had to resign my position as foreign adviser to the Bank of Japan. Since that time, steady increases in financial institutions' current account deposits at the Bank of Japan has resulted in 68 percent increase in the monetary base, an average annual growth rate of 22 percent. In addition, good communication with the market from Mr. Fukui has increased market confidence in the Bank of Japan's commitment to end deflation.

There is evidence that the Bank of Japan's more aggressive approach may be starting to pay off. Consumer prices excluding fresh food rose for the first time in over 5 years in October. But it is still too early to declare victory in Japan's long struggle against deflation. Some of the apparent easing of deflation is due to special factors that have increased prices this year.

I agree with those that say the Bank of Japan should wait some time before raising interest rates above zero and abandoning its current policy of strong monetary base increases. Inflation is barely positive. It is still well below common measures of price stability. There is still excess capacity. Standard monetary policy guidelines suggest that the interest rate should be held at zero until price stability is more firmly established and output grows much closer to potential. Both will take time.

Fortunately, the Bank of Japan recognizes that the time has not yet come to abandon its anti-deflation efforts. In October, the Monetary Policy Board judiciously assured the markets that its current policy will continue until deflation is clearly in the past.

Another key reason for optimism about the sustainability of the current recovery is the recent progress in bank and corporate sector reforms. The resolution of Ahikaga Bank and Resona Bank are genuine signs of progress. Those actions showed that last year's measures to improve the valuation of bank assets and capital are effective, and that Japan's regulators and auditors can and will resist political pressures to "go easy" on the banks. They demonstrated the Japanese authorities' ability to move quickly and effectively to resolve weak banks, while avoiding financial and economic disruption. Perhaps most important, replacing top management and imposing costs on shareholders showed the government's commitment to setting the right incentives—a key to achieving a longer-term solution to the banking system's problems.

On the corporate side, firms have strengthened their balance sheets by paying down debt. They have cut costs and increased operating margins, even in the midst of deflation. They have begun to restructure to focus more on their core strengths. Listed companies have begun to pay more attention to shareholders and rates of return. As a result of these efforts, corporate profits have increased sharply, supporting future investment and growth.

Another good sign is that, unlike past recoveries that depended heavily on public works spending, this time growth has been led by the private sector. From 1992 to 2000, the Japanese Government spent over $1 trillion in stimulus packages to jump-start recovery. These did not bring about sustained growth, but they did leave Japan with a huge deficit and the largest public debt of any G7 country. This time is different. Government spending, and public works spending in particular, has fallen during the current recovery.

Not all indicators are positive, of course. Japanese economic prospects are still highly dependent on exports. For a durable recovery, Japan needs more balanced growth where domestic spending grows with income. This is why the structural reform and deregulation agenda of the Koizumi administration is so important. It has the potential to open up new opportunities for investment and growth. The deregulation of the domestic mobile phone industry in the mid-1990's, which spurred demand for base station and transmission facilities as well as for handsets, is a clear example of deregulation's power to spur domestic activity. Similar opportunities exist in health care and care for the elderly, housing, and a host of domestic services.

Progress in retail deregulation has allowed far more competition, with benefits for consumers and the economy as a whole. Many medical services businesses have been deregulated. And there has been progress in IT deregulation.

I hope we can look forward to more progress, such as the reduction in regulatory barriers that continue to limit competition in many economic sectors, including transportation and food processing.

Continued reforms will also be useful to increase new firm creation and entrepreneurial activity in Japan. The "Global Entrepreneurship Monitor" listed Japan last among 37 countries in its 2002 Total Entrepreneurial Activity Index. Japan was also near the bottom of those indexes, which are based on the percentage of the working age population involved in starting a new business, or an owner/manager of a business that is less than 42 months old, in previous years. Removing regulatory barriers to competition can help, as will the emergence of a healthier financial system that is better able to support entrepreneurial activity.

The key to taking advantage of these opportunities is economic flexibility – the ability to respond to price signals both in the domestic and world economy, and to shift resources to most productive uses. The reforms Prime Minister Koizumi is pursuing will help promote the economic flexibility needed to take advantage of those opportunities.

Flexible exchange rate regimes among the world's major trading countries are a key part of maintaining economic flexibility. That is why we have entered discussions with China—an increasingly important trading partner for Japan and the United States—about the steps needed to pursue their announced goal of moving toward a more flexible exchange rate regime.

And while Japan has made progress in dealing with its banking sector problems, non-performing loans are still a problem. It is true that bank profits rose sharply in the first half of this year, but some of this was due to gains on stock holdings and to tax rebates from the Tokyo municipal government. Solid profitability on core business operations of banks still has to be established.

Japan now has much of the legal and institutional infrastructure needed for corporate restructuring, and the workout process for distressed, over-indebted borrowers is beginning. But incentives are still skewed towards rolling over debt and postponing borrower problems. Unresolved loan claims have created an overhang of land, capital, and labor locked in unproductive activities that blocks resource mobility and discourages investment. I have argued in the past that ending the deflation problem will help improve incentives because positive interest rates will reduce incentives for debt rollover.

As I mentioned, policymakers in Japan now recognize that fiscal stimulus is not the key to sustained growth. The Koizumi administration has changed the way in which people view government spending. It has also framed the debate in realistic terms – how to achieve a primary budget balance over time. There is now a very healthy debate going on in Japan on how to meet public pension obligations and limit the rise in the contribution ratio – a debate that was spurred on by the recent election campaign.

A credible, transparent multi-year framework for restoring public finances would do much to ease the pain of fiscal consolidation in Japan, and increase the public's confidence in the future.

In sum, there are clear signs that things have changed in Japan. The building blocks for sustained, robust economic growth are being established. Further reform efforts will be needed across the spectrum of economic policy to ensure stronger growth. As the Koizumi Government continues to implement banking, regulatory, and other reform measures, a brighter economic future is in store.

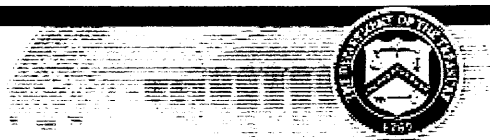
PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 5, 2003
JS-1042

Statement of Secretary John Snow on Employment Report

Today's employment rate report is further evidence that the economy is on the right path, but there is much more that needs to be done. For the fourth consecutive month, more Americans are finding jobs and unemployment is lower. However, despite signs that the economy is moving in the right direction, the effort must remain ongoing. We will not be satisfied until every American looking for work can find a job. Enactment of the President's six point plan for job creation is critical for continuing more new jobs and economic growth.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 5, 2003
JS-1043

U.S. Designates Individual Tied to Attacks on European Tourists

WASHINGTON -- The U.S. Treasury Department today announced the designation of an individual for involvement in terrorism. Today's action comes in response to the designation of this individual as a terrorist by the United Nations.

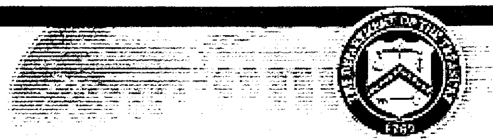
The individual, Saifi Ammari was the leader of a region for the Salafist Group for Preaching and Combat ("GSPC"), an organization previously designated by the United States as a specially designated global terrorist, and designated by the United Nations, because of its ties to al-Qaida. Earlier this year, Ammari's group orchestrated the kidnapping of thirty-two tourists while they were traveling in four-by-four vehicles, on motor bikes, and in camper vans in an area between Illizi, Djanet, and Tanjanrasset, Algeria. The kidnappings occurred over a period of several weeks. Sixteen Germans, ten Austrians, four Swiss, one Dutch, and one Swede were held hostage by the group. In May 2003, the Algerian army managed to free 17 tourists from the kidnappers. The kidnappers escaped. In June, one of the remaining hostages died as a result of the extreme conditions. After negotiations, the remaining hostages were released on August 18, 2003. The hostages identified Ammari as the Emir of the group.

The German public prosecutor's office issued a warrant for the arrest of Ammari on September 11, 2003. The charges are based on Ammari's responsibility for masterminding, as the operational leader, the kidnapping of the hostages and his role as leader of a GSPC region. The GSPC has been on the list of the UN's al-Qaida/Taliban Sanctions Committee since October 6, 2001.

Today's action is taken under obligations to freeze the assets of individuals and organizations listed by the UN. The name was originally submitted to the UN by another country for listing. A UN listing requires all Member States to freeze the assets of those listed and to bar cross-border travel. The UN listed this individual on Thursday, December 4th.

With today's action, the U.S. and our international partners have designated 344 individuals and organizations as terrorists and terrorist supporters and have frozen over $136.8 million in terrorist assets.

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

December 8, 2003
JS-1044

Bush Administration Announces Principles for Postal Reform

The Bush administration today called on Congress to enact comprehensive postal reform to ensure that the United States Postal Service can continue to provide affordable and reliable universal service, while limiting exposure of taxpayers and operating appropriately in the competitive marketplace. United States Postal Service reform should be guided by a set of clear principles outlined by the administration:

Implement Best Practices: Ensure that the Postal Service's governing body is equipped to meet the responsibilities and objectives of an enterprise of its size and scope.

Transparency: Ensure that important factual information on the Postal Service's product costs and performance is accurately measured and made available to the public in a timely manner.

Flexibility: Ensure that the Postal Service's governing body and management have the authority to reduce costs, set rates, and adjust key aspects of its business in order to meet its obligations to customers in a dynamic marketplace.

Accountability: Ensure that a Postal Service operating with greater flexibility has appropriate independent oversight to protect consumer welfare and universal mail service.

Self Financing: Ensure that a Postal Service operating with greater flexibility is financially self-sufficient, covering all of its obligations.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 8, 2003
JS-1045

Treasury Secretary Snow Statement On Health Savings Accounts

Today, the President signed the Medicare Prescription Drug legislation into law. This is an important victory for the health of America's senior citizens.

An important provision in the bill greatly expands the former Medical Savings Accounts into new and innovative Health Savings Accounts ("HSA"s). HSAs provide an important and welcome option for many Americans to fund their health care expenses.

Treasury is committed to ensuring that taxpayers get the full benefit of HSAs as quickly as possible. We will be releasing basic information and guidance about HSAs shortly, and will request suggestions about how the rules should be applied. In addition, we expect to issue more detailed guidance.

-30-

FACT SHEET·
HEALTH SAVINGS ACCOUNTS

• The Medicare billed signed by the President today creates new Health Savings Accounts (HSAs) to help individuals save for qualified medical and retiree health expenses on a tax-free basis.

• Beginning on January 1, 2004, individuals under the age of 65 are eligible to contribute to an HSA if they have a qualified health plan.

o For self-only policies, a qualified health plan must have a minimum deductible of $1,000 with a $5,000 cap on out-of-pocket expenses (indexed annually).

o For family policies, a qualified health plan must have a minimum deductible of $2,000 with a $10,000 cap on out-of-pocket expenses (indexed annually).

• Preventive care services, as well as coverage for accidents, disability, dental care, vision care, and long-term care is not subject to the deductible.

• Individuals may contribute up to 100% of the health plan deductible. The maximum annual contribution is $2,600 for self-only policies and $5,150 for family policies (indexed annually).

• Individuals age 55 – 65 may make additional "catch-up" contributions of up to $500 in 2004, increasing to $1,000 annually in 2009 and thereafter. A married couple can make two catch-up contributions as long as both spouses are at least 55.

• Contributions may be made by individuals, family members and employers and are tax deductible, even if the account beneficiary does not itemize. Employer contributions are made on a pre-tax basis and are not taxable to the employee. Employers will be allowed to offer HSAs through a cafeteria plan.

• Investment earnings accrue tax-free.

• HSA distributions are tax-free if they are used to pay for qualified medical expenses. Qualified expenses include prescription drugs, qualified long-term care services and long-term care insurance, COBRA coverage, Medicare expenses (but not Medigap), and retiree health expenses for individuals age 65 and older.

• Distributions made for any other purpose are subject to income tax and a 10% penalty. The 10% penalty is waived in the case of death or disability. The 10% penalty is also waived for distributions made by individuals age 65 and older.

• Upon death, HSA ownership may transfer to the spouse on a tax-free basis.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 9, 2003
JS-1046

MEDIA ADVISORY
Secretary Snow to Host Meeting of African Finance Ministers to discuss African Growth and Opportunity Act

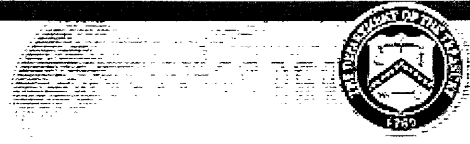
On Wednesday, December 10, 2003 at 8:00 a.m.EST, Treasury Secretary John Snow will host a meeting with finance ministers from African nations to discuss the African Growth and Opportunity Act (AGOA). The meeting will be held in the Treasury Department's Cash Room, 1500 Pennsylvania Avenue, NW.

Since the program began, AGOA has proven to be a vital tool for economic growth and development in sub-Saharan Africa, stimulating trade opportunities for African businesses, empowering local entrepreneurs, delivering much-needed investment and creating jobs. Secretary Snow will discuss will discuss with finance ministers the economic impact of AGOA and future prospects for expanding trade and investment links with sub-Saharan Africa.

The TOP of the meeting will be OPEN PRESS.

The Cash Room will be available for pre-set at 7:00 a.m.

Media without Treasury or White House press credentials planning to attend should contact Treasury's Office of Public Affairs at (202) 622-2960 with the following information: name, social security number and date of birth. This information may also be faxed to (202) 622-1999.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 9, 2003
JS-1047

Remarks of Acting Under Secretary of the Treasury for Domestic Finance, Brian Roseboro on the Next Generation Financial Services Information Sharing and Analysis Center Washington, DC

It is a great pleasure to be here today, to help launch the next generation Financial Services Information Sharing and Analysis Center, better known to some of you as the FSISAC.

The United States has a $12 trillion economy and about $4 trillion in funds flow daily through the financial system.

In a very real sense, the financial system is the life blood of our economy. Any significant disruption in this flow of funds would severely affect our economic growth and our standard of living. Accordingly, the Department of the Treasury wholeheartedly supports the mission of FSISAC, which will enhance the resiliency of the thousands of financial institutions that comprise the financial sector.

FSISAC was created in 1999 in response to a Presidential Directive. At that time, the United States recognized the growing threats to our infrastructure, particularly from an increasing onslaught of computer viruses, worms, and hackers. FSISAC did a commendable job of responding to those threats as we understood them at the time. I wish to acknowledge and thank Rhonda MacLean, who is with us today, for her role in establishing the original FSISAC, as well as her continued leadership.

Since 1999, of course, much has changed. The terrorist attacks of September 11th, made clear that we faced new physical threats to our infrastructure. At the same time, the speed and maliciousness of cyber threats has increased exponentially.

The next generation FSISAC is designed to meet these new threats. It will service the entire financial services sector. It will integrate physical and cyber threat information. It will provide a state-of-the-art technology platform for the confidential exchange of information as the financial sector works together to respond to emerging physical and cyber threats. This will be a key component of the extraordinary resiliency of the financial system of the United States.

President Bush has designated the Department of the Treasury as the lead agency to coordinate the protection of our critical financial infrastructure. After receiving this charge, the Department of the Treasury made the development of a next-generation FSISAC a top priority. We worked with FSISAC, our sister financial regulators in the "Financial and Banking Information Infrastructure Committee", and private sector members of the "Financial Services Sector Coordinating Council", to develop a business plan for the next generation. This business plan was based on extensive market research documenting that a new, improved FSISAC could serve the entire sector and support itself through private sector funding.

At the same time, however, our research convinced us that the FSISAC must make significant investments to upgrade its technological infrastructure if it is to serve the entire sector and deliver a product that would elicit ongoing, private sector support. The Department of the Treasury stands ready to acquire approximately $2 million in services from FSISAC, which should have the added benefit of making the Next Generation FSISAC a reality.

In closing, I want to commend Suzanne Gorman for both her vision and her dedication. Without her tireless leadership, we would not be here today. Given her significant time spent in Washington, I know that she has a "day job" in New York with the Securities Industry Automation Corporation. So the Securities Industry Automation Corporation should also be congratulated for allowing her to spend so much of her time on an effort that benefits all of us.

Thank you.

FROM THE OFFICE OF PUBLIC AFFAIRS

December 9, 2003
2003-12-9-17-0-22-2046

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $86,038 million as of the end of that week, compared to $85,309 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*

	November 28, 2003			December 5, 2003		
TOTAL		85,309			86,038	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	7,988	14,361	22,349	8,113	14,594	22,707
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	13,083	2,885	15,968	13,265	2,932	16,197
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			23,769			23,863
3. Special Drawing Rights (SDRs) [2]			12,179			12,227
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	November 28, 2003			December 5, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0

2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:

2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	November 28, 2003			December 5, 2003		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be subject to revision. IMF data for the prior week are final.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

To view or print the PDF content on this page, download the free Adobe® Acrobat® Reader®.

December 9, 2003
js-1048

Statement From Treasury Secretary John Snow On The Announcement Of The Next Generation Financial Services Information Sharing And Analysis Center

The American financial system is one of the most resilient in the world. While we have worked very hard to strengthen the infrastructure that supports it and prepare for events both expected and unthinkable, we must continue to make strides to increase our preparedness and anticipate new threats.

The Department of the Treasury announced today that we will acquire $2 million in services from the Financial Services Information Sharing and Analysis Center (FS-ISAC), a critical component of the financial sector's system of infrastructure protection. This significant investment will help the FS-ISAC enhance its mission and capabilities.

This Next Generation FS-ISAC will help the financial sector better prepare to face the new physical threats that we have confronted since the attacks of September 11, 2001, as well as the increasing speed and maliciousness of cyber attacks.

At the heart of our ability to protect our financial system from attack or disruption is the sharing of information between government and the private sector, as well as information sharing among individual financial institutions. The Next Generation FS-ISAC will provide real time, accurate information about emerging physical and cyber threats to the entire financial community in a confidential and secure manner.

By working together, the public and private sectors will continue to make great progress in protecting the American financial sector, the millions of Americans that is serves, and our economy as a whole in ways that neither could achieve on its own.

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Related Documents:

- Fact Sheet

- Include over 16 quantitative measures of the FS-ISAC's effectiveness that will enable the leadership of the FS-ISAC and the Department of the Treasury to assess both the FS-ISAC's performance and the aggregate state of information sharing within the industry in response to particular threats.

This $2 million contract is a one-time expenditure to upgrade the technology supporting the FS-ISAC. Based on extensive market research, the FS-ISAC and the Department of the Treasury believe that the FS-ISAC can, by the end of FY 2005, be funded entirely by membership fees paid by the private sector.

The next-generation FS-ISAC has four membership levels depending upon the services that are provided. The most basic membership level is free. The three other membership levels are priced at $750, $10,000, and $50,000. Financial institutions interested in learning more about the FS-ISAC can do so at www.fsisac.com.

President George W. Bush designated the Department of the Treasury as the lead agency charged with enhancing the resilience of the banking and finance sector. In addition, Congress recently expressed interest in improving the technological infrastructure of the FS-ISAC. Today, the Department of the Treasury took important strides toward fulfilling its role as the lead agency charged with critical financial infrastructure protection.

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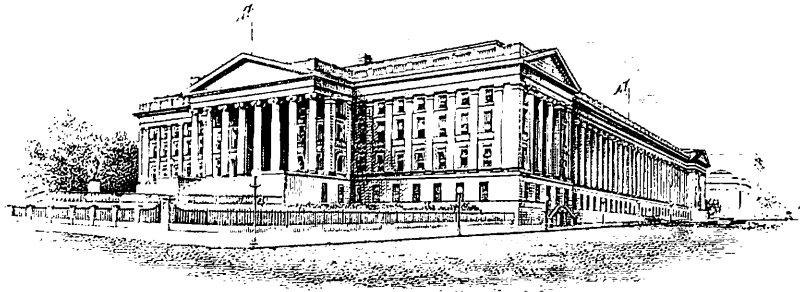


DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

FOR IMMEDIATE RELEASE
December 9, 2003

Contact: Anne Womack Kolton
(202) 622-2960

FACT SHEET:
ANNOUNCEMENT OF THE NEXT GENERATION FINANCIAL SERVICES INFORMATION SHARING AND ANALYSIS CENTER

Today, Treasury announced that it would purchase $2 million in services from the Financial Services Information Sharing and Analysis Center (FS-ISAC).

The FS-ISAC is a private organization run by leading firms in the financial services sector. The mission of the FS-ISAC is to disseminate information about threats to the financial infrastructure and to facilitate information sharing by financial institutions as they respond to particular threats.

Treasury's contract with the FS-ISAC will result in a new, next-generation FS-ISAC that will benefit Treasury, other financial regulators, and the private sector. Specifically, the $2 million will:

- Transform the FS-ISAC from a technology platform that serves approximately 80 financial institutions to one that serves the entire 30,000 institution financial sector including banks, credit unions, securities firms, insurance companies, commodity futures merchants, exchanges, and others.

- Provide a secure, confidential forum for financial institutions to share information among each other as they respond in real-time to particular threats.

- Add information about physical threats to the cyber threat information that the FS-ISAC currently disseminates.

- Include an advance notification service that will notify member financial institutions of threats. The primary means of notification will be by internet. If, however, internet traffic is disrupted, the notification will be by other means including telephone calls and faxes.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 9, 2003
JS-1049

Statement of Treasury Secretary John Snow on Azie Taylor Morton

The Treasury Department is saddened to learn of the death of Azie Taylor Morton, the nation's first African American U.S. Treasurer. Our thoughts and prayers are with her family and friends.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 10, 2003
JS-1050

U.S. Treasury Secretary John W. Snow Remarks to AGOA Forum Breakfast

Let me thank you for your participation in the Africa Growth and Opportunity Act (AGOA) Forum and for being with us here at Treasury this morning.

We are committed to this process and want to see a great success made of it. As you know, Treasury has the lead in representing the US government at the IMF, the multi-lateral development banks and the Paris Club.

As one of AGOA's sponsoring agencies, along with the State Dept., Commerce Dept. and the USTA, we have a deep interest in the AGOA process and the continuing dialogue with you on a broad range of topics.

It is important that we stimulate closer trade and investment relations with the countries of sub-Saharan Africa, promoting market-led growth in the region.

Beyond promoting trade, we are also interested in promoting the essentials of a vibrant economy, as reflected in the theme of this year's forum "Building Trade, Expanding Investment."

AGOA seeks to promote stable and lasting growth through a strong macro-economic framework, reliance on market economy principles, the rule of law and active commitment to decrease poverty.

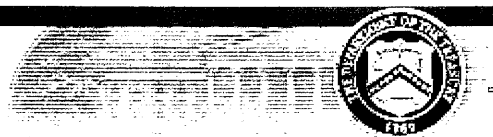
We see an important role for private sector in promoting growth and expanding investments and developing capital markets. Treasury has been actively involved in promoting the SME financing initiative through IFC-IDA, through promotion of grant lending and by helping countries achieve sovereign credit ratings.

Housing and housing finance is one of the principle drivers of US economic development. It was enormously important in helping us through the recent recession where despite the stock market fall-off housing industry remains strong.

Housing could serve an important development role for many African countries, proving opportunities for small and medium enterprises, deepening the retail banking sector and promoting the development of domestic capital markets. You have an excellent topic for discussion and I regret that I won't be able to be here for the entire meeting, but Assistant Secretary Quarles and his staff will be here to engage in the dialogue with you.

I look forward to working with you in the future to attain these goals.

Thank you.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 10, 2003
JS-1051

Treasury Secretary Snow Praises Assistant Secretary Pam Olson for Leadership and Accomplishments While Serving in Bush Administration

Treasury Secretary John W. Snow today praised the leadership and accomplishments of Assistant Secretary for Tax Policy Pamela F. Olson during her service to the Bush Administration. Ms. Olson joined Treasury as Deputy Assistant Secretary for Tax Policy in February 2001 and was sworn in as Assistant Secretary for Tax Policy September 26, 2002. Today she submitted her resignation to the President, effective after the budget is completed.

"Pam has shown outstanding leadership within Treasury and the Administration on a wide variety of issues over the past several years," said Secretary Snow. "Her expertise has been invaluable as we have worked to promote policies that have resulted in economic growth and job creation. Millions of families have benefited from her efforts in ensuring that the President's Jobs and Growth Tax Relief was enacted.

"Pam's effort to continually improve and streamline federal tax policies and practices has greatly benefited the taxpayer and her significant contributions to the government are to be commended. Her passion, experience and insight will be missed, and I wish her the best in her future endeavors. She is a rare public servant and she simply cannot be praised too highly for her dedication and service to the President and the country."

Ms. Olson's major accomplishments during her tenure as Assistant Secretary include her efforts to enact policies that reduce taxes, increase economic growth and boost job creation; simplify the tax code so that it is fair, easy to understand, easy for taxpayers to comply with and easy for the IRS to administer; cracking down on abusive tax avoidance transactions; improving the guidance process; and improving the revenue estimating process.

Related Documents:

- The Text of Olson's Resignation Letter to the President

December 10, 2003

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

It has been my privilege and honor to serve you and this great country for the past three years. Unfortunately, I have found it extremely difficult to balance the requirements of the office with time for my family. Consequently, I have concluded that the time has come for me to return to the private sector to allow me to spend more time with them, and I am writing to resign as Assistant Secretary of the Treasury for Tax Policy. To allow for a smooth transition, Secretary Snow requested that my resignation be effective after the completion of the fiscal year 2005 budget.

Under your leadership, we have taken important steps toward a tax system consistent with our values and our best interests as a nation. Your principles, your values, and your commitment to doing what is right have resulted in change far beyond the incremental change that too often marks our progress. I am proud of what we have accomplished over the last three years and pleased to have had the opportunity to play a role in promoting policies that have resulted in economic growth and job creation. We have also taken important steps over the last three years to restore the confidence of American taxpayers in the tax system, which was shaken by the excesses of the 1990s. I appreciate the opportunity that I have had to work with the talented staff of the Office of Tax Policy and the Internal Revenue Service to achieve those goals.

May God bless you as you continue to lead our country.

Very truly yours,

Pamela F. Olson

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 10, 2003
JS-1052

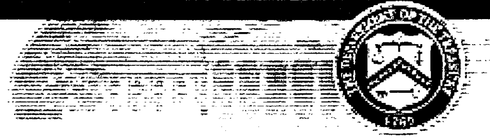
Statement by Secretary Snow
Following a Meeting Today at The Treasury Department with Secretary Baker

Today, Secretary Jim Baker and I had the opportunity to continue our discussions on the effort to help Iraq restructure and reduce its official debt. I assured Secretary Baker the Treasury will continue to provide necessary resources to support his vital mission. I welcome Secretary Baker as the President's personal envoy to work with heads of state. He will complement my efforts working with finance ministers and the international financial institutions and Secretary Powell's efforts with his counterparts. In our meeting we also briefly discussed the nature of Iraq's debt and strategies to resolve this issue. We agreed that it is imperative to move quickly to solve this problem if the Iraqi people are to have a chance to succeed as a free, democratic and prosperous nation. As President Bush said, the issue of Iraq's debt must be resolved in a manner that is fair and that does not unjustly burden a struggling nation at its moment of hope and promise.

Related Documents:

- (1) Photo of Secretary Snow During a Meeting with Secretary Baker
- (2) Photo of Secretary Snow During a Meeting with Secretary Baker

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

December 10, 2003
JS-1052photo-1

Photo of Secretary Snow During a Meeting Today at The Treasury Department with Secretary Baker

Media Contact
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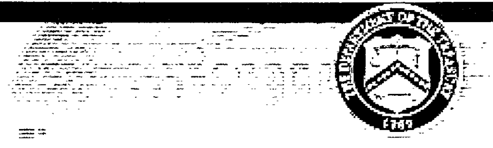
The Press Office at (202) 622-2960.
Only call this number if you are a member of the media.

High Resolution Image



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 10, 2003
JS-1052photo-2

Photo of Secretary Snow During a Meeting Today at The Treasury Department with Secretary Baker

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 12, 2003
JS-1053a

Treasury Issues Revised Regulations On Inversion Transaction Reporting

Today the Treasury Department issued revised temporary regulations requiring corporations to notify the IRS and their shareholders when they move their headquarters offshore or are acquired by a foreign company. Temporary regulations were first released on November 12, 2002, and covered transactions occurring after 2001. These revised regulations cover transactions occurring after 2002 and reflect clarifications that will ensure better information reporting by brokers. These regulations are part of Treasury's proposals to address corporate inversion transactions, which were unveiled by Treasury Assistant Secretary Pam Olson in testimony before the House Ways & Means Committee on June 6, 2002.

The texts of the revised temporary and proposed regulations are attached. They will be published in the Federal Register in the next few days and are subject to minor technical changes.

-30-

Related Documents:

- Text of Revised Temporary Regulations
- Text of Proposed Regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD]

RIN 1545-BC79

Information Reporting Relating to Taxable Stock Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations requiring information reporting by a corporation if control of the corporation is acquired or if the corporation has a recapitalization or other substantial change in capital structure. This document also contains temporary regulations concerning information reporting requirements for brokers with respect to transactions described in section 6043(c). The text of these temporary regulations also serves as the text of proposed regulations set forth in the Proposed Rules section of this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.6043-4T(i) and 1.6045-3T(g).

FOR FURTHER INFORMATION CONTACT: Nancy Rose at (202) 622-4910 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The forms referenced in these regulations have been, or will be, reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

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

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 6043(c) provides that if any person acquires control of a corporation, or if there is a recapitalization or other substantial change in capital structure of a corporation, the corporation, when required by the Secretary, shall make a return setting forth the identity of the parties to the transaction, the fees involved, the changes in the capital structure involved, and such other information as the Secretary may require with respect to such transaction.

On November 18, 2002, the IRS published temporary regulations under section 6043(c) (TD 9022). The transactions covered by the reporting requirement were certain acquisitions of control and substantial changes in the capital structure of a corporation. These regulations required a corporation to attach a form to its income tax return describing these transactions and to file information returns with respect to certain shareholders in such transactions. On November 18, 2002, the IRS also published temporary regulations under section 6045, which

provided for information reporting with respect to these transactions by brokers (together with the section 6043(c) temporary regulations, the 2002 temporary regulations). The 2002 temporary regulations were applicable to acquisitions of control and substantial changes in capital structure occurring after December 31, 2001, if the reporting corporation or any shareholder was required to recognize gain (if any) as a result of the application of section 367(a) as a result of the transaction.

The text of the 2002 temporary regulations also served as the text of proposed regulations set forth in a cross-referencing notice of proposed rulemaking published in the Proposed Rules section of the same issue of the **Federal Register** (2002 proposed regulations) (REG-143321-02). The provisions of the proposed regulations were proposed to apply with respect to any acquisition of control or substantial change in capital structure occurring after the date on which final regulations would be published in the **Federal Register**. The preamble to the notice of proposed rulemaking invited public comments with respect to the potential for duplicate reporting and with respect to the burden of compliance with the reporting requirements.

The IRS received a number of written public comments with respect to the information reporting requirements set forth in the 2002 temporary and proposed regulations. In addition, the IRS met with representatives of the Information Reporting Program Advisory Committee (IRPAC) and other representatives of the securities industry to discuss their concerns and suggestions for revisions to the regulations.

After considering the issues concerning affected taxpayers, the IRS has decided to revise the 2002 temporary regulations. The revised temporary regulations set forth information reporting rules that will help ensure that brokers and shareholders receive information regarding

these corporate transactions, without unduly burdening brokers and other members of the securities industry.

The text of the revised temporary regulations also serves as the text of new proposed regulations (reproposed regulations) set forth in the cross-referencing notice of proposed rulemaking published in the proposed rules section of this issue of the Federal Register. The preamble to that notice of proposed rulemaking invites public comments with respect to the revised temporary and reproposed regulations, particularly with respect to the ability of brokers to obtain the information necessary for reporting under revised §1.6045-3T and proposed §1.6045-3.

Summary of Comments

The commentators noted certain gaps in the transmission of information under the 2002 temporary and proposed regulations between corporations subject to reporting and brokers. Information reporting by brokers depends upon the effective dissemination of information from the corporation to the reporting community, and broker reporting is difficult to effectuate if there are gaps in the process of transmitting this information.

As provided in the 2002 temporary regulations, a reporting corporation would file Forms 1099-CAP, "Changes in Corporate Control and Capital Structure", with respect to its shareholders of record, including brokers, under §1.6043-4T(b). Brokers who received Forms 1099-CAP would then file Forms 1099-CAP with respect to their customers pursuant to §1.6045-3T. The commentators pointed out that a large majority of U.S. publicly issued securities are actually held on behalf of brokerage firms through clearing organizations. Pursuant to the 2002 temporary regulations, clearing organizations would receive Forms 1099-CAP from the reporting corporation; however, because clearing organizations are not treated as brokers, they in turn would not be required under §1.6045-3T to file Forms 1099-CAP with respect to their

broker-members. Consequently, brokers (who otherwise had the requirement to file a Form 1099-CAP upon receiving one) would not receive Form 1099-CAP if they held their shares through a clearing organization. In addition, brokers may not be aware of the requirement to report with respect to a particular corporate transaction, or may have difficulty obtaining the information necessary for reporting. Thus, under the 2002 temporary regulations, the actual shareholders of the reporting corporation, the broker's customers, may not receive information returns to assist them in preparing their income tax returns.

To address this issue, commentators suggested an alternative procedure to ensure that brokers receive the required information for reporting and to bridge any potential gaps in the chain of reporting. Commentators recommended that the IRS act as a central repository of information necessary for brokers and issue a publication containing information needed for brokers to satisfy their reporting obligations. Brokers and commercial tax services that publish current developments could access this information, and brokers could use this information in preparing Forms 1099-CAP with respect to their customers. An alternative suggested by commentators was to require the reporting corporation to post essential information for reporting, from its Form 8806, "Information Return for Acquisition of Control or Substantial Change in Capital Structure", to an IRS website.

Based on the comments, the revised temporary regulations provide in §1.6043-4T(a)(1)(vi) that reporting corporations may elect on Form 8806 to consent to the publication by the IRS of information necessary for brokers to file information returns with respect to their customers. To provide every corporation with the ability to make this election, the revised temporary regulations require reporting corporations to file Form 8806 even though the corporation may also report the transaction under sections 351, 355, or 368. In order to enable

the IRS to publish the information timely, the revised temporary regulations require reporting corporations to file Form 8806 within 45 days after the transaction, and in no event later than January 5 of the year following the calendar year in which the transaction occurs.

The role of clearing organizations was also the subject of comments. Commentators suggested that the regulations use existing processes for distributing information to minimize the cost of and the time required for implementing reporting by the industry. Those existing processes include the dissemination of information by clearing organizations. Under current practices, important information regarding corporate transactions (including tax information) is disseminated by clearing organizations to their members. The new temporary regulations try to take advantage of this existing information flow by continuing to require corporations to provide a Form 1099-CAP to clearing organizations that are listed as shareholders of record at the time of an acquisition of control or substantial change in capital structure. It is anticipated that clearing organizations will disseminate information obtained from the Form 1099-CAP to their members and that broker-members will use that information (and information obtained from other sources) to satisfy their own reporting obligations under revised §1.6045-3T. Under the revised temporary regulations, a broker is required to report information if the broker knows or has reason to know, based on readily available information, that there was an acquisition of control or substantial change in capital structure with respect to shares held by the broker on behalf of a customer. If a clearing organization disseminates information identifying an acquisition of control or a substantial change in capital structure to a broker-member, the broker-member has readily available information about the transaction and must satisfy its §1.6045-3T reporting obligations with respect to the transaction.

The revised temporary regulations provide that a reporting corporation is not required to file Forms 1099-CAP with respect to its shareholders which are clearing organizations, or to furnish Forms 1099-CAP to such clearing organizations, if the corporation makes the election to permit the IRS to publish information regarding the transaction. The IRS' publication of such information pursuant to the corporation's consent will provide readily available information for brokers, who must satisfy their reporting obligations with respect to the transaction.

Commentators also requested that brokers be permitted to use Form 1099-B, "Proceeds from Broker and Barter Exchange Transactions," for reporting under §1.6045-3T, rather than overhaul their systems to report on Form 1099-CAP. The commentators point out that this would also avoid any confusion stemming from the issuance of both types of forms to the same taxpayer in the same transaction. The revised temporary regulations provide that Form 1099-B should be used by brokers for reporting under §1.6045-3T. With respect to transactions occurring in 2003, brokers may use either Form 1099-B or 1099-CAP.

Explanation of Provisions

The revised temporary regulations require a domestic corporation involved in certain large taxable transactions to file Form 8806 reporting and describing such transactions. The revised temporary regulations require the filing of Form 8806 within 45 days following an acquisition of control or substantial change in capital structure, as defined in §§1.6043-4T(c) and (d), or, if earlier, by January 5th of the year following the calendar year in which such event occurred.

The revised temporary regulations do not change the definition of acquisition of control or substantial change in capital structure as set forth in the 2002 temporary regulations. An acquisition of control of a corporation is defined as a transaction or series of related transactions in which stock representing control of that corporation is distributed by a second corporation or

in which stock representing control of that corporation is acquired (directly or indirectly) by a second corporation and the shareholders of the first corporation receive cash, stock or other property. For these purposes, control is determined in accordance with the first sentence of section 304(c)(1). With certain limitations, the constructive ownership rules of section 318(a) apply to determine ownership. Acquisitions of control within an affiliated group are excepted from this definition, as are acquisitions in which the fair market value of the stock acquired in the transaction or series of related transactions is less than $100,000,000.

A corporation has a substantial change in its capital structure if the corporation in a transaction or series of related transactions (a) undergoes a recapitalization with respect to its stock, (b) redeems its stock, (c) merges, consolidates or otherwise combines with another entity or transfers substantially all of its assets to one or more entities, (d) transfers all or part of its assets to another corporation in a title 11 or similar case and, in pursuance of the plan, distributes stock or securities of that corporation, or (e) changes its identity, form or place of organization. Transactions in which the amount of any cash plus the fair market value of any property (including stock) provided to shareholders of the corporation is less than $100,000,000 are excepted from this definition, as are transactions within an affiliated group.

The revised temporary regulations require a domestic corporation involved in the specified transactions to issue, with respect to each of its shareholders of record, a Form 1099-CAP reporting the amount of any cash plus the fair market value of any property (including certain stock) exchanged in the transaction. Corporations are not required to report the fair market value of any stock provided to a shareholder if the corporation reasonably determines that the receipt of such stock would not cause the shareholder to recognize gain (if any).

Corporations also are not required to report amounts distributed to certain exempt recipients. The list of exempt recipients has been expanded to include brokers.

Penalties under section 6652(l) may be imposed for failing to file required returns under section 6043(c) (including failure to file on magnetic media, as required under section 6011(e) and §1.6011-2). The penalty under section 6652(l) is $500 for each day the failure continues, but the total amount imposed with respect to a return cannot exceed $100,000. The revised temporary regulations provide that the information returns required under these regulations shall be treated as one return for purposes of the section 6652(l) penalty, so that the penalty shall not exceed $500 per day ($100,000 in total) with respect to any acquisition of control or change in capital structure. Further, as provided in section 6652(l), such penalty does not apply if the failure is due to reasonable cause. Until regulations are promulgated under section 6652(l) to set forth specific standards for determining reasonable cause, the IRS will use the reasonable cause standards set forth in §301.6724-1 as a guideline for determining reasonable cause.

The 2002 temporary regulations under section 6045 required a broker who, as the record holder of stock, received a Form 1099-CAP from a corporation pursuant to the reporting requirements of §1.6043-4T to file a Form 1099-CAP with respect to the actual owner and furnish such Form 1099-CAP to the actual owner. Under the revised temporary regulations, brokers should not receive Forms 1099-CAP from a corporation and are not required to issue Forms 1099-CAP. Instead, revised §1.6045-3T requires a broker that knows or has reason to know, based on readily available information, that a transaction described in §1.6043-4T(c) or (d) has occurred to file an information return reporting the required information with respect to its customers who are not exempt recipients. In order to allow brokers to use their existing information reporting systems, the new temporary regulations require Form 1099-B, Proceeds

from Broker and Barter Exchange Transactions, to be used for such reporting. It is anticipated that brokers will obtain the information regarding the corporate transactions from the IRS website or an IRS publication, from information provided by clearing organizations, as well as from other sources regularly consulted within the industry.

The revised temporary regulations are effective only for acquisitions of control and substantial changes of capital structure that occur after December 31, 2002, and for which the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a). The cross-referencing proposed regulations published in Proposed Rules section of this issue of the **Federal Register** will apply to all acquisitions of control and substantial changes in capital structure occurring after the date that such regulations are published as final regulations (regardless of whether section 367(a) applies).

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 the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be 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 temporary regulations is Nancy L. Rose, Office of Associate Chief Counsel (Procedure and Administration).

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

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 continues to read in part as follows:

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

Par. 2. Section 1.6043-4T is revised to read as follows:

§1.6043-4T Information returns relating to certain acquisitions of control and changes in capital structure (temporary).

(a) Information returns for an acquisition of control or a substantial change in capital structure-- (1) General rule. If there is an acquisition of control (as defined in paragraph (c) of this section) or a substantial change in the capital structure (as defined in paragraph (d) of this section) of a domestic corporation (reporting corporation), the reporting corporation must file a completed Form 8806, "Information Return for Acquisition of Control or Substantial Change in Capital Structure", in accordance with the instructions to that form. Form 8806 will request the information required in paragraphs (a)(1)(i) through (vi) of this section and any other information specified in the instructions.

(i) Reporting corporation. Provide the name, address, and taxpayer identification number (TIN) of the reporting corporation.

(ii) Common parent, if any, of the reporting corporation. If the reporting corporation was a subsidiary member of an affiliated group filing a consolidated return immediately prior to the acquisition of control or the substantial change in capital structure, provide the name, address, and TIN of the common parent of that affiliated group.

(iii) Acquiring corporation. Provide the name, address and TIN of any corporation that acquired control of the reporting corporation within the meaning of paragraph (c) of this section or combined with or received assets from the reporting corporation pursuant to a substantial change in capital structure within the meaning of paragraph (d) of this section (acquiring corporation). State whether the acquiring corporation is foreign (as defined in section 7701(a)(5)) or is a dual resident corporation (as defined in §1.1503-2(c)(2)). In either case, state whether the acquiring corporation was newly formed prior to its involvement in the transaction.

(iv) Common parent, if any, of acquiring corporation. If the acquiring corporation named in paragraph (a)(1)(iii) of this section was a subsidiary member of an affiliated group filing a consolidated return immediately prior to the acquisition of control or the substantial change in capital structure, provide the name, address, and TIN of the common parent of that affiliated group.

(v) Information about acquisition of control or substantial change in capital structure. Provide--

(A) A description of the transaction or transactions that gave rise to the acquisition of control or the substantial change in capital structure of the corporation;

(B) The date or dates of the transaction or transactions that gave rise to the acquisition of control or the substantial change in capital structure;

(C) A description of and a statement of the fair market value of any stock provided to the reporting corporation's shareholders in exchange for their stock if the reporting corporation reasonably determines that the shareholders are not required to recognize gain (if any) from the receipt of such stock for U.S. federal income tax purposes; and

(D) A statement of the amount of cash plus the fair market value of any property (including stock if the reporting corporation reasonably determines that its shareholders would be required to recognize gain (if any) on the receipt of such stock, but excluding stock described in paragraph (a)(1)(v)(C) of this section) provided to the reporting corporation's shareholders in exchange for each share of their stock.

(2) Consent election. Form 8806 will provide the reporting corporation with the ability to elect to permit the IRS to publish information that will inform brokers of the transaction and enable brokers to satisfy their reporting obligations under §1.6045-3T. The information to be published, on the IRS website and/or in an IRS publication, would be limited to the name and address of the corporation, the date of the transaction, a description of the shares affected by the transaction, and the amount of cash and the fair market value of any property (excluding stock described in paragraph (a)(1)(v)(C) of this section) provided to each class of shareholders in exchange for a share.

(3) Time for making return-- (i) In general. Form 8806 must be filed on or before the 45th day following the acquisition of control or substantial change in capital structure of the corporation, or, if earlier, on or before January 5th of the year following the calendar year in which the acquisition of control or substantial change in capital structure occurs.

(ii) Transition rule. If an acquisition of control or a substantial change in capital structure of a corporation occurs after December 31, 2002, and before [**INSERT DATE THIS**

DOCUMENT IS FILED WITH THE OFFICE OF THE FEDERAL REGISTER], Form 8806 must be filed on or before January 5, 2004.

(4) Exception where transaction is reported under section 6043(a). No reporting is required under paragraph (a) of this section with respect to a transaction for which information is required to be reported pursuant to section 6043(a), provided the transaction is properly reported in accordance with that section.

(5) Exception where shareholders are exempt recipients. No reporting is required under paragraph (a) of this section if the reporting corporation reasonably determines that all of its shareholders who receive cash, stock or other property pursuant to the acquisition of control or substantial change in capital structure are exempt recipients under paragraph (b)(5) of this section.

(b) Information returns regarding shareholders--(1) General rule. A corporation that is required to file Form 8806 pursuant to paragraph (a)(1) of this section shall file a return of information on Forms 1096, "Annual Summary and Transmittal of U.S. Information Returns", and 1099-CAP, "Changes in Corporate Control and Capital Structure", with respect to each shareholder of record in the corporation (before or after the acquisition of control or the substantial change in capital structure) who receives cash, stock, or other property pursuant to the acquisition of control or the substantial change in capital structure and who is not an exempt recipient as defined in paragraph (b)(5) of this section. A corporation is not required to file a Form 1096 or 1099-CAP with respect to a clearing organization if the corporation makes the election described in paragraph (a)(2) of this section.

(2) Time for making information returns. Forms 1096 and 1099-CAP must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the acquisition of control or the substantial change in capital structure occurs.

(3) Contents of return. A separate Form 1099-CAP must be filed with respect to amounts received by each shareholder (who is not an exempt recipient as defined in paragraph (b)(5) of this section) showing--

(i) The name, address, telephone number and TIN of the reporting corporation;

(ii) The name, address and TIN of the shareholder;

(iii) The number and class of shares in the reporting corporation exchanged by the shareholder;

(iv) The aggregate amount of cash and the fair market value of any stock (other than stock described in paragraph (a)(1)(v)(C) of this section) or other property provided to the shareholder in exchange for its stock; and

(v) Such other information as may be required by the instructions to Form 1099-CAP.

(4) Furnishing of forms to shareholders. The Form 1099-CAP filed with respect to each shareholder must be furnished to such shareholder on or before January 31 of the year following the calendar year in which the shareholder receives cash, stock, or other property as part of the acquisition of control or the substantial change in capital structure. The Form 1099-CAP filed with respect to a clearing organization must be furnished to the clearing organization on or before January 5th of the year following the calendar year in which the acquisition of control or substantial change in capital structure occurred. A Form 1099-CAP is not required to be furnished to a clearing organization if the reporting corporation makes the election described in paragraph (a)(2) of this section.

(5) Exempt recipients. A corporation is not required to file a Form 1099-CAP pursuant to this paragraph (b) of this section with respect to any of the following shareholders that is not a clearing organization:

(i) Any shareholder who receives solely stock described in paragraph (a)(1)(v)(C) of this section in exchange for its stock in the corporation.

(ii) Any shareholder who is required to recognize gain (if any) as a result of the receipt of cash, stock, or other property if the corporation reasonably determines that the amount of such cash plus the fair market value of such stock and other property does not exceed $1,000. Stock described in paragraph (a)(1)(v)(C) of this section is not taken into account for purposes of this paragraph (b)(5)(ii).

(iii) Any shareholder described in paragraphs (b)(5)(iii)(A) through (M) of this section if the corporation has actual knowledge that the shareholder is described in one of paragraphs (b)(5)(iii)(A) through (M) of this section or if the corporation has a properly completed exemption certificate from the shareholder (as provided in §31.3406(h)-3 of this chapter). The corporation also may treat a shareholder as described in paragraphs (b)(5)(iii)(A) through (M) of this section based on the applicable indicators described in §1.6049-4(c)(1)(ii).

(A) A corporation, as described in section §1.6049-4(c)(1)(ii)(A)(except for corporations for which an election under section 1362(a) is in effect).

(B) A tax-exempt organization, as described in §1.6049-4(c)(1)(ii)(B)(1).

(C) An individual retirement plan, as described in §1.6049-4(c)(1)(ii)(C).

(D) The United States, as described in §1.6049-4(c)(1)(ii)(D).

(E) A state, as described in §1.6049-4(c)(1)(ii)(E).

(F) A foreign government, as described in §1.6049-4(c)(1)(ii)(F).

(G) An international organization, as described in §1.6049-4(c)(1)(ii)(G).

(H) A foreign central bank of issue, as described in §1.6049-4(c)(1)(ii)(H).

(I) A securities or commodities dealer, as described in §1.6049-4(c)(1)(ii)(I).

(J) A real estate investment trust, as described in §1.6049-4(c)(1)(ii)(J).

(K) An entity registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1), as described in §1.6049-4(c)(1)(ii)(K).

(L) A common trust fund, as described in §1.6049-4(c)(1)(ii)(L).

(M) A financial institution such as a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization.

(iv) Any shareholder that the corporation, prior to the transaction, associates with documentation upon which the corporation may rely in order to treat payments to the shareholder as made to a foreign beneficial owner in accordance with §1.1441-1(e)(1)(ii) or as made to a foreign payee in accordance with §1.6049-5(d)(1) or presumed to be made to a foreign payee under §1.6049-5(d)(2) or (3). For purposes of this paragraph (b)(5)(iv), the provisions in §1.6049-5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. The provisions of §1.1441-1 shall apply by using the terms corporation and shareholder in place of the terms withholding agent and payee and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Internal Revenue Code. The provisions of §1.6049-5(d) shall apply by using the terms corporation and shareholder in place of the terms payor and payee. Nothing in this paragraph (b)(5)(iv) shall be construed to relieve a corporation of its withholding obligations under section 1441.

(v) Any shareholder if, on January 31 of the year following the calendar year in which the shareholder receives cash, stock, or other property, the corporation did not know and did not have reason to know that the shareholder received such cash, stock, or other property in a transaction or series of related transactions that would result in an acquisition of control or a substantial change in capital structure.

(6) Coordination with other sections. In general, no reporting is required under paragraph (b) of this section with respect to amounts that are required to be reported under section 6042 or section 6045, unless the corporation knows or has reason to know that such amounts are not properly reported in accordance with those sections. A corporation must satisfy the requirements under paragraph (b) of this section with respect to any shareholder of record that is a clearing organization.

(c) Acquisition of control of a corporation--(1) In general. For purposes of this section, an acquisition of control of a corporation (first corporation) occurs if, in a transaction or series of related transactions, either--

(i) Stock representing control of the first corporation is distributed by a second corporation to shareholders of the second corporation and the fair market value of such stock on the date of distribution is $100,000,000 or more; or

(ii) (A) Before an acquisition of stock of the first corporation (directly or indirectly) by a second corporation, the second corporation does not have control of the first corporation;

(B) After the acquisition, the second corporation has control of the first corporation;

(C) The fair market value of the stock acquired in the transaction and in any related transactions as of the date or dates on which such stock was acquired is $100,000,000 or more; and

(D) The shareholders of the first corporation (determined without applying the constructive ownership rule of section 318(a)) receive cash, stock, or other property pursuant to the acquisition.

(2) Control. For purposes of this section, control is determined in accordance with the first sentence of section 304(c)(1).

(3) Constructive ownership. (i) Except as otherwise provided in this section, the constructive ownership rules of section 318(a) (except for section 318(a)(4), providing for constructive ownership through an option to acquire stock), modified as provided in section 304(c)(3)(B), shall apply for determining whether there has been an acquisition of control.

(ii) The determination of whether there has been an acquisition of control shall be made without regard to whether the person or persons from whom control was acquired retain indirect control of the first corporation under section 318(a).

(iii) For purposes of paragraph (c)(1)(ii) of this section, section 318(a) shall not apply to cause a second corporation to be treated as owning, before an acquisition of stock in a first corporation (directly or indirectly) by the second corporation, any stock that is acquired in the first corporation. For example, if the shareholders of a domestic corporation form a new holding company and then transfer their shares in the domestic corporation to the new holding company, the new holding company shall not be treated as having control of the domestic corporation before the acquisition. The new holding company acquires control of the domestic corporation as a result of the transfer. Similarly, if the shareholders of a domestic parent corporation transfer their shares in the parent corporation to a subsidiary of the parent in exchange for shares in the subsidiary, the subsidiary shall not be treated as having control of the parent before the transaction. The subsidiary acquires control of the parent as a result of the transfer.

(4) Corporation includes group. For purposes of this paragraph (c), if two or more corporations act pursuant to a plan or arrangement with respect to acquisitions of stock, such corporations will be treated as one corporation for purposes of this section. Whether two or more corporations act pursuant to a plan or arrangement depends on the facts and circumstances.

(5) Section 338 election. For purposes of this paragraph (c), an acquisition of stock of a corporation with respect to which an election under section 338 is made is treated as an acquisition of stock (and not as an acquisition of the assets of such corporation).

(d) Substantial change in capital structure of a corporation--(1) In general. A corporation has a substantial change in capital structure if it has a change in capital structure (as defined in paragraph (d)(2) of this section) and the amount of any cash and the fair market value of any property (including stock) provided to the shareholders of such corporation pursuant to the change in capital structure, as of the date or dates on which the cash or other property is provided, is $100,000,000 or more.

(2) Change in capital structure. For purposes of this section, a corporation has a change in capital structure if the corporation in a transaction or series of transactions--

(i) Undergoes a recapitalization with respect to its stock;

(ii) Redeems its stock (including deemed redemptions);

(iii) Merges, consolidates or otherwise combines with another corporation or transfers all or substantially all of its assets to one or more corporations;

(iv) Transfers all or part of its assets to another corporation in a title 11 or similar case and, in pursuance of the plan, distributes stock or securities of that corporation; or

(v) Changes its identity, form or place of organization.

(e) Reporting by successor entity. If a corporation (transferor) transfers all or substantially all of its assets to another entity (transferee) in a transaction that constitutes a substantial change in the capital structure of transferor, transferor must satisfy the reporting obligations in paragraph (a) or (b) of this section. If transferor does not satisfy the reporting obligations in paragraph (a) or (b) of this section, then transferee must satisfy those reporting obligations. If neither transferor nor transferee satisfies the reporting obligations in paragraphs (a) and (b) of this section, then transferor and transferee shall be jointly and severally liable for any applicable penalties (see paragraph (g) of this section).

(f) Receipt of property. For purposes of this section, a shareholder is treated as receiving property (or as having property provided to it) pursuant to an acquisition of control or a substantial change in capital structure if a liability of the shareholder is assumed in the transaction and, as a result of the transaction, an amount is realized by the shareholder from the sale or exchange of stock.

(g) Penalties for failure to file. For penalties for failure to file as required under this section, see section 6652(l). The information returns required to be filed under paragraphs (a) and (b) of this section shall be treated as one return for purposes of section 6652(l) and, accordingly, the penalty shall not exceed $500 for each day the failure continues (up to a maximum of $100,000) with respect to any acquisition of control or any substantial change in capital structure. Failure to file as required under this section also includes the requirement to file on magnetic media as required by section 6011(e) and §1.6011-2. In addition, criminal penalties under sections 7203, 7206 and 7207 may apply in appropriate cases.

(h) Examples. The following examples illustrate the application of the rules of this section. For purposes of these examples, assume the transaction is not reported under sections 6042, 6043(a) or 6045, unless otherwise specified, and assume that the fair market value of the consideration provided to the shareholders exceeds $100,000,000. The examples are as follows:

Example 1. The shareholders of X, a domestic corporation and parent of an affiliated group, exchange their X stock for stock in Y, a newly-formed foreign holding corporation. After the transaction, Y owns all the outstanding X stock. The X shareholders must recognize gain (if any) on the exchange of their stock as a result of the application of section 367(a). Because the transaction results in an acquisition of control of X, X must comply with the rules in paragraphs (a) and (b) of this section. X must file Form 8806 reporting the transaction. X must also file a Form 1099-CAP with respect to each shareholder who is not an exempt recipient showing the fair market value of the Y stock received by that shareholder, and X must furnish a copy of the Form 1099-CAP to that shareholder. If X elects on the Form 8806 to permit the IRS to publish information regarding the transaction, X is not required to file or furnish Forms 1099-CAP with respect to shareholders that are clearing organizations.

Example 2. C, a domestic corporation, and parent of an affiliated group merges into D, an unrelated domestic corporation. Pursuant to the transaction, the C shareholders exchange their C stock for D stock or for a combination of short term notes and D stock. The transaction does not satisfy the requirements of section 368, and the C shareholders must recognize gain (if any) on the exchange. Because the transaction results in a substantial change in the capital structure of C, C (or D as the successor to C) must comply with the rules in paragraphs (a) and (b) of this section. C must file Form 8806. C (or D as the successor to C) also must file a Form 1099-CAP with respect to each shareholder who is not an exempt recipient showing the fair market value of the short term notes and the fair market value of the D stock provided to that shareholder. In addition, C (or D) must furnish a copy of the Form 1099-CAP to that shareholder.

Example 3. (i) The facts are the same as in Example 2, except that C reasonably determines that--

(A) The transaction satisfies the requirements of section 368;

(B) The C shareholders who exchange their C stock solely for D stock will not be required to recognize gain (if any) on the exchange; and

(C) The C shareholders who exchange their C stock for a combination of short term notes and D stock will be required to recognize gain (if any) on the exchange solely with respect to the receipt of the short term notes.

(ii) C is required to file Form 8806 under paragraph (a) of this section. C (or D as the successor to C) must also comply with the rules in paragraph (b) of this section. With respect to each shareholder who receives a combination of short term notes and D stock, and who is not an exempt recipient, C (or D) must file a Form 1099-CAP showing the fair market value of the short term notes provided to the shareholder, and C (or D) must furnish a copy of the Form 1099-CAP to that shareholder. The Form 1099-CAP should not show the fair market value of the D stock provided to the shareholder. C and D are not required to file and furnish Forms 1099-CAP with respect to shareholders who receive only D stock in exchange for their C stock.

Example 4. The facts are the same as in Example 3, except C hires a transfer agent to effectuate the exchange. The transfer agent is treated as a broker under section 6045 and is required to report the fair market value of the short term notes provided to C's shareholders under §1.6045-3T. Under paragraph (b)(6) of this section, C and D are not required to file information returns under paragraph (b) of this section with respect to a shareholder of record, unless C or D knows or has reason to know that the transfer agent does not satisfy its information reporting obligation under §1.6045-3T with respect to that shareholder. Thus, if the transfer agent satisfies its information reporting requirements under §1.6045-3T with respect to shareholder I, an individual who receives both D stock and short term notes, C and D are not required to file a Form 1099-CAP with respect to I. Conversely, if the transfer agent does not have an information reporting obligation under §1.6045-3T with respect to one of C's shareholder's of record (for example, a clearing organization that is an exempt recipient under §1.6045-3T(b)(ii)), or if C or D knows or has reason to know that the transfer agent has not satisfied its information reporting requirement with respect to a shareholder, then C (or D) must provide a Form 1099-CAP to that shareholder.

(i) Effective date. This section applies to any acquisition of control and any substantial change in capital structure occurring after December 31, 2001, if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a) as a result of the transaction. However, paragraphs (a) through (h) of this section apply to acquisitions of control and substantial changes in capital structure occurring after December 31, 2002, if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a) as a result of the transaction. For transactions prior to January 1, 2003, see §1.6043-4T as published in 26 CFR Part 1 (revised as of April 1, 2003). This section expires on November 14, 2005.

Par. 3. Section 1.6045-3T is revised to read as follows:

§1.6045-3T Information reporting for an acquisition of control or a substantial change in capital structure (temporary).

(a) In general. Any broker (as defined in §1.6045-1(a)(1)) that holds shares on behalf of a customer in a corporation that the broker knows or has reason to know based on readily available information (including, for example, information from a clearing organization or from information published by the Internal Revenue Service (see §601.601(d)(2) of this chapter)) has engaged in a transaction described in §1.6043-4T(c) (acquisition of control) or §1.6043-4T(d) (substantial change in capital structure), shall file a return of information with respect to the customer, unless the customer is an exempt recipient as defined in paragraph (b) of this section.

(b) Exempt recipients. A broker is not required to file a return of information under this section with respect to the following customers:

(i) Any customer who receives only cash in exchange for its stock in the corporation, which must be reported by the broker pursuant to §1.6045-1(a).

(ii) Any customer who is an exempt recipient as defined in §1.6043-4T(b)(5) or §1.6045-1(c)(3)(i).

(c) Form, manner and time for making information returns. The return required by paragraph (a) of this section must be on Forms 1096, "Annual Summary and Transmittal of U.S. Information Returns", and 1099-B, "Proceeds from Broker and Barter Exchange Transactions,"

or on an acceptable substitute statement. Such forms must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the acquisition of control or the substantial change in capital structure occurs.

(d) Contents of return. A separate Form 1099-B must be prepared for each customer showing--

(1) The name, address and taxpayer identification number (TIN) of the customer;

(2) The name and address of the corporation which engaged in the transaction described in §1.6043-4T(c) or (d);

(3) The number and class of shares in the corporation exchanged by the customer;

(4) The aggregate amount of cash and the fair market value of any stock (other than stock described in 1.6043-4T(a)(1)(v)(C)) or other property provided to the customer in exchange for its stock; and

(5) Such other information as may be required by Form 1099-B.

(e) Furnishing of forms to actual owners. The Form 1099-B prepared for each customer must be furnished to the customer on or before January 31 of the year following the calendar year in which the customer receives stock, cash or other property.

(f) Single Form 1099. If a broker is required to file a Form 1099-B with respect to a customer under both this §1.6045-3T and §1.6045-1(b) with respect to the same transaction, the broker may satisfy the requirements of both sections by filing and furnishing one Form 1099-B that contains all the relevant information, as provided in the instructions to Form 1099-B.

(g) Effective date. (i) This section applies with respect to any acquisition of control and any substantial change in capital structure occurring after December 31, 2001, if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a) as a result of the transaction. However, paragraphs (a) through (f) of this section apply to acquisitions of control and substantial changes in capital structure occurring after December 31, 2002, if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a) as a result of the transaction. For transactions prior to that date, see §1.6045-3T as published in 26 CFR Part 1 (revised as of April 1, 2003). This section expires on November 14, 2005.

(ii) For any acquisition of control or any substantial change in capital structure occurring during the 2003 calendar year, a broker may elect to satisfy the requirements of this section by using Form 1099-CAP in lieu of Form 1099-B.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

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

Par. 5. In §602.101, paragraph (b) is amended by removing the following entries in the table as follows:

§602.101 OMB Control numbers

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.6043-4T	1545-1812
* * * * *	
1.6045-3T	1545-1812
* * * * *	

Deputy Commissioner for Services and Enforcement.

Approved:

Assistant Secretary of the Treasury (Tax Policy).

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-143321-02; REG-156232-03]

RIN 1545-BB60; RIN 1545-BC80

Information Reporting Relating to Taxable Stock Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of previous proposed rules; notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: This document withdraws proposed regulations published in the **Federal Register** on November 18, 2002 (REG-143321-02). In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing temporary regulations relating to information reporting relating to taxable stock transactions. This document contains proposed regulations under section 6043(c) requiring information reporting by a corporation if control of the corporation is acquired or if the corporation has a recapitalization or other substantial change in capital structure. This document also contains proposed regulations under section 6045 concerning information reporting requirements for brokers with respect to transactions described in section 6043(c). The text of the temporary regulations serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by

[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]. Outlines of topics to be discussed at the public hearing scheduled for ___________, at ___________, must be received by **[INSERT DATE THAT IS 3 WEEKS BEFORE THE HEARING]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-156232-03), room 5203, Internal Revenue Service, POB 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-156232-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in room ___________, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Nancy L. Rose (202) 622-4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, ___________ at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The forms referenced in these regulations have been, or will be, approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the

collection of information displays a valid OMB control number.

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

This document withdraws the Notice of Proposed Rulemaking (REG-143321-02) that was published in the **Federal Register** on November 18, 2002 (67 FR 65496). Temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** amend the Income Tax Regulations (26 CFR Part 1) relating to sections 6043 and 6045. The temporary regulations set forth information reporting requirements relating to acquisitions of control and substantial changes in capital structure. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments and these proposed regulations.

On November 18, 2002, the IRS published temporary regulations under section 6043(c) (TD 9022). The transactions covered by the reporting requirement were certain acquisitions of control and substantial changes in the capital structure of a corporation. These regulations required a corporation to attach a form to its income tax return describing these transactions and to file information returns with respect to certain shareholders in such transactions. On November 18, 2002, the

IRS also published temporary regulations under section 6045, which provided for information reporting with respect to these transactions by brokers (together with the section 6043(c) temporary regulations, the "2002 temporary regulations". The 2002 temporary regulations were effective for acquisitions of control and substantial changes in capital structure occurring after December 31, 2001, if the reporting corporation or any shareholder was required to recognize gain (if any) as a result of the application of section 367(a) as a result of the transaction.

The text of the 2002 temporary regulations also served as the text of proposed regulations set forth in a cross-referencing notice of proposed rulemaking published in the Proposed Rules section of the same issue of the **Federal Register** (2002 proposed regulations) (REG-143321-02). The provisions of the proposed regulations were proposed to be effective with respect to any acquisition of control or substantial change in capital structure occurring after the date on which final regulations would be published in the **Federal Register**. The preamble to the notice of proposed rulemaking invited public comments with respect to the potential for duplicate reporting and with respect to the burden of compliance with the reporting requirements.

The IRS received a number of written public comments with respect to the information reporting requirements set forth in the 2002 temporary and proposed regulations. In addition, the IRS met with representatives of the Information Reporting

Program Advisory Committee (IRPAC) and other representatives of the securities industry to discuss their concerns and suggestions for revisions to the regulations.

After considering the issues concerning affected taxpayers, the IRS has decided to revise the 2002 temporary regulations. The revised temporary regulations set forth information reporting rules that will help ensure that brokers and shareholders receive information regarding these corporate transactions, without unduly burdening brokers and other members of the securities industry. The text of the revised temporary regulations also serves as the text of these proposed regulations (reproposed regulations).

Summary of Comments and Explanation of Provisions

The commentators noted certain gaps in the transmission of information under the 2002 temporary and proposed regulations between corporations subject to reporting and brokers. Information reporting by brokers depends upon the effective dissemination of information from the corporation to the reporting community, and broker reporting is difficult to effectuate if there are gaps in the process of transmitting this information.

As provided in the 2002 temporary and proposed regulations, a reporting corporation would file Forms 1099-CAP, "Changes in Corporate Control and Capital Structure", with respect to its shareholders of record, including brokers, under §1.6043-4T(b) and proposed §1.6043-4(b). Brokers who received Forms 1099-CAP would then file Forms 1099-CAP with respect to their customers

pursuant to §1.6045-3T and proposed §1.6045-3. The commentators pointed out that a large majority of U.S. publicly issued securities are actually held on behalf of brokerage firms through clearing organizations. Pursuant to the 2002 temporary and proposed regulations, clearing organizations would receive Forms 1099-CAP from the reporting corporation; however, because clearing organizations are not treated as brokers, they in turn would not be required under §1.6045-3T and reproposed §1.6045-3 to file Forms 1099-CAP with respect to their broker-members. Consequently, brokers (who had the requirement to file a Form 1099-CAP upon receiving one) would not receive Form 1099-CAP if they held their shares through a clearing organization. In addition, brokers may not be aware of the requirement to report with respect to a particular corporate transaction, or may have difficulty obtaining the information necessary for reporting. Thus, under the 2002 temporary and proposed regulations, the actual shareholders of the reporting corporation, the broker's customers, may not receive information returns to assist them in preparing their income tax returns.

To address this issue, commentators suggested an alternative procedure to ensure that brokers receive the required information for reporting and to bridge any potential gaps in the chain of reporting. Commentators recommended that the IRS act as a central repository of information necessary for brokers and issue a publication containing information needed for brokers to satisfy their reporting obligations. Brokers and commercial tax services that publish current developments could

access this information, and brokers could use this information in preparing Forms 1099-CAP with respect to their customers. An alternative suggested by commentators was to require the reporting corporation to post essential information for reporting, from its Form 8806,"Information Return for Acquisition of Control or Substantial Change in Capital Structure," to an IRS website.

Based on the comments, revised §1.6043-4T(a)(1)(vi) and reproposed §1.6043-4(a)(1)(vi) provide that reporting corporations may elect on Form 8806 to consent to the publication by the IRS of information necessary for brokers to file information returns with respect to their customers. To provide every corporation with the ability to make this election, the revised temporary regulations require reporting corporations to file Form 8806 even though the corporation may also report the transaction under sections 351, 355, or 368. In order to enable the IRS to publish the information timely, the revised temporary regulations require reporting corporations to file Form 8806 within 45 days after the transaction, and in no event later than January 5 of the year following the calendar year in which the transaction occurs.

The role of clearing organizations was also the subject of comments. Commentators suggested that the regulations utilize existing processes for distributing information to minimize the cost of and the time required for implementing reporting by the industry. Those existing processes include the dissemination of information by clearing organizations. Under current practices,

important information regarding corporate transactions (including tax information) is disseminated by clearing organizations to their members. The revised temporary and reproposed regulations try to take advantage of this existing information flow by continuing to require corporations to provide a Form 1099-CAP to clearing organizations that are listed as shareholders of record at the time of an acquisition of control or substantial change in capital structure. It is anticipated that clearing organizations will disseminate information obtained from the Form 1099-CAP to their members and that broker-members will use that information (and information obtained from other sources) to satisfy their own reporting obligations under section §1.6045-3T and reproposed §1.6045-3. Under the revised regulations, a broker is required to report information if the broker knows or has reason to know, based on readily available information, that there was an acquisition of control or substantial change in capital structure with respect to shares held by the broker on behalf of a customer. If a clearing organization disseminates information identifying an acquisition of control or a substantial change in capital structure to a broker-member, the broker-member has readily available information about the transaction and must satisfy its reporting obligations under §1.6045-3T and reproposed §1.6045-3 with respect to the transaction.

The revised temporary and reproposed regulations provide that a reporting corporation is not required to file Forms 1099-CAP with respect to its shareholders which are clearing

organizations, or to furnish Forms 1099-CAP to such clearing organizations, if the corporation makes the election to permit the IRS to publish information regarding the transaction. The IRS' publication of such information pursuant to the corporation's consent will provide readily available information for brokers, who must satisfy their reporting obligations with respect to the transaction.

Commentators also requested that brokers be permitted to utilize Form 1099-B for reporting under §1.6045-3T and reproposed §1.6045-3, rather than overhaul their systems to report on Form 1099-CAP. The commentators point out that this would also avoid any confusion stemming from the issuance of both types of forms to the same taxpayer in the same transaction. The revised temporary regulations and reproposed regulations provide that Form 1099-B should be used by brokers for reporting under §1.6045-3T and reproposed §1.6045-3. With respect to transactions occurring in 2003, brokers may use either Form 1099-B or 1099-CAP.

Proposed Effective Date

The provisions of these regulations are proposed to be applicable for any acquisition of control and change in capital structure occurring after the date on which these regulations are published in the **Federal Register** as final regulations.

Special Analyses

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

not required. It 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, 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 Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing has been scheduled for ________, beginning at ______ in Room ____, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit electronic

or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by ___________. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of this notice of proposed rulemaking is Nancy L. Rose, Office of Associate Chief Counsel (Procedure and Administration).

List of Subjects in 26 CFR part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of a Previous Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking published in the **Federal Register** on November 18, 2002 (REG-143321-02) 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 continues to read in part as follows:

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

Par. 2. Section 1.6043-4 is added to read as follows:

§1.6043-4 Information returns relating to certain acquisitions of control and changes in capital structure.

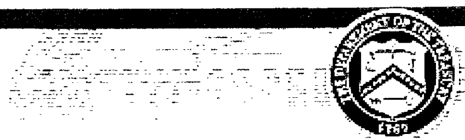
[The text of proposed §1.6043-4 is the same as the text of §1.6043-4T published elsewhere in this issue of the **Federal Register**]

Par. 3. Section 1.6045-3 is added to read as follows:

§1.6045-3 Information reporting for acquisitions of control or substantial changes in capital structure.

[The text of proposed §1.6045-3 is the same as the text of §1.6045-3T published elsewhere in this issue of the **Federal Register**]

Deputy Commissioner for Services and Enforcement.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 13, 2003
JS-1054

U.S Treasury Secretary John W. Snow
Commencement Address to Virginia Commonwealth University
December 13, 2003
Richmond, Virginia

Congratulations! Thank you for inviting me to speak to you today on this important occasion. I've had a long and personal connection with Virginia Commonwealth University, so it's a special pleasure to see so many successful graduates here at VCU.

Thank you, President Trani, for bestowing this honorary degree upon me. Gene, you've done so much for this University, as a visionary and a builder. You've done a lot for this campus.

This is a great institution in so many ways. A strong business school, one of the best art programs in the country, a leading biotechnology research center, a new engineering school, and my favorite, one of the top tennis teams around. And there's so much more. VCU is a wonderful place – and I'm not just saying that because my own son goes here.

So first of all, my heartiest congratulations to you the graduates. I understand one thing very clearly; a commencement speech is the last thing to stand between you and your degree, so I know my duty well. At some commencements, speakers go on and on like wind blowing through a desert. Some of my own graduations went like that, bringing to mind the comment of a forlorn speaker who apparently went on too long. He said, "I don't mind people looking at their watches when I'm speaking, but I do take exception when they start shaking their watches to make sure they still work."

This is a great day for you the graduates, your friends, parents and loved ones. But I'll bet there's at least one question on many of your minds today. No, not "who's the old guy with the bushy eyebrows?" You're wondering about jobs, and what the future holds for you – will I be able to find a good job? That's natural. It was the question on my mind when I graduated. It should be on your mind today, and it's on my mind as well.

The basic question is, where do jobs come from? One thing we know for sure is that education plays a big role.

You know jobs and education are closely linked. Otherwise you wouldn't be here. Many of you are continuing education graduates – you've been out in the workforce before, maybe a few times. You know it takes education to understand your opportunities, to create opportunities, and to exploit them.

Living in the United States, you live in the most dynamic, innovative, economy in the world. We're at the forefront of every industry and every technology. Change is always in the air. The workplace is ever changing, with some industries losing jobs, and others creating jobs. Over time, there's always more of the latter than the former, but to grab hold of the wave, you need education – you need to be prepared for the opportunities. That's what a good education does for you.

And it isn't just the knowledge you take with you. That's perishable. Knowledge or skills quickly become obsolete unless constantly upgraded. That's the real secret of a good education. It's the gift that keeps on giving. Because a good education provides you with the ability to keep on learning – and lifetime learning is the key to

your success in the dynamic, ever-changing economy.

I'll share with you a figure that illuminates my point. Over the past decade in the United States, around 30 million jobs have been lost every year, give or take a few million. In fact, in the year 2000, when unemployment hit its lowest point in the decade, 33 million jobs were lost. That sounds pretty bad, doesn't it? After ten years of losing 30 million jobs a year, the whole country should be out of work, and then some.

The key is that over the same period, about 30 million jobs were created every year, give or take a few million. In some years the gain is slighter greater than the loss. In other years – the opposite is true.

It sounds chaotic, but that is the path of progress. Look at history. A hundred years ago 40% of the U.S. workforce was in agriculture, at a time when our population totaled 90 million. Today, agriculture accounts for less than 2% of our workforce and we're a nation of nearly 300 million people, and we're better fed as a nation, and we're doing more to feed the rest of the world as well.

Imagine the United States today with 40% of its workforce in farming. How many of you studied agriculture? If 2 out of 5 workers were in farming today, we wouldn't have enough people for our growth industries such as information technology, biotechnology and healthcare.

Agriculture is honorable work – farmers feed our nation, and our nation feeds much of the world. But today, we're able to do that job with far fewer people. That's an economic success story in the big picture, but it caused countless individual dislocations, as folks moved from the country to the cities over the course of a century, and took up new work. It's still happening today, and it's tough on a lot of families.

The new jobs are often different from the old jobs because our economy keeps changing and creating new opportunities. We keep getting more productive. It takes less time to do the same amount of work, thanks to better education and better technology. So as we keep getting more productive, workers get paid more for what they do because they are getting more done.

That's good, but the market requires everybody to be on their toes. The dynamic of the marketplace leads to the constant creation of new businesses and new jobs to go where the growth is.

The truth is, in America, there will always be plenty of jobs created for everyone, as long as Americans are free to create them.
So how do jobs get created? Where will we find the jobs of the future?
Jobs come from new ideas, from discovery, from innovations. And by their very nature the innovations of the future are not known today. They require risk-taking and overcoming uncertainty, and they require lifelong learning.

I don't know where new jobs will come from, in biotech or software, ball bearings or space exploration. Or maybe something I've never heard of, but something one of you has been researching every day for two years. I don't know exactly where they'll come – that's why we have markets – but I know how they'll come: from capital and labor finding the most productive opportunities in the market, from new ideas, and from investors and innovators prepared to risk their time and capital to create something new.

In the American economy, new ideas are always displacing old ideas; new management processes are displacing old management processes; new technologies are displacing older technologies. And all the while, productivity is rising, the standard of living is rising, and wealth is rising. People have the opportunity to lead more abundant lives.

Interwoven in all of this is education. To work or invest or invent on the frontiers of our economy, to ride the wave, you need education. You need training. You need flexibility. That's true whether you're looking for your first job out of college, or you're a venture capitalist putting a million dollars into the biotech startup of a newly minted VCU grad.

Let me give you an example of the need for lifelong learning. No one is too smart to need further education. Alan Greenspan, the eminent chairman of the Federal Reserve, is well known for his deep erudition and mastery of financial matters. I was talking with Alan some years back. He told me he had gone back to the books, the mathematics books, to master the complex mathematical theory behind derivatives.

Alan explained that derivatives were becoming a bigger and bigger part of what the Federal Reserve System needed to be concerned about. And derivatives, which are highly sophisticated investment tools, are based on a system of underlying mathematical constructs.

Think of that: the Chairman of the Federal Reserve Board, who years ago got a PhD in economics, one of the leading financial figures in the world, goes back to the books. But that is the world we are in; that is the world you are entering. You can never be satisfied with what you know. Instead, draw strength from what you have learned about how to learn. Learn through studying, and learn through doing.

People that pursue a new opportunity are taking a risk. They often fail. The key is that they learn, and try again. The secret of American economic success is failure! – or perhaps that we allow people to fail and start over again. If it were easy to exploit new opportunities, they wouldn't be opportunities for long.

Those who take the risks – with their time, money, and reputations, must be able to claim their reward when they succeed, and learn their lessons when they fail. A lot of people learned lessons in the dotcom boom and bust, for example. Maybe some of you. Some succeeded, but many did not. But there's no stigma for having worked for a start-up that failed. In fact, in many quarters, it's a right of passage.

And that risk with your time – that includes education. Many of you stepped out of the work force, you passed up jobs you could have had, because you felt that with a better education, you could do better for yourself. You took a tougher road for a greater reward. You had that confidence in your abilities, your ability to learn, and your future. You made the right choice.

I'll tell you another thing – since exchanging my job in Richmond for one in Washington, I've been impressed. I've been impressed with our President's understanding of exactly these issues. He knows the importance of lifelong learning, in education and training, and he knows the value of incentives for investment and job creation.

President Bush's administration is striving to encourage entrepreneurship, capital formation, and education. This year's tax program was the first in decades to focus on reducing taxes on capital formation, such as taxes on dividends and capital gains. At the same time, the President's "No Child Left Behind" Act invests more in education, and it introduces key concepts of innovation and competition into the market for education. In education, as in business, there should be rewards for success.

And we're seeing success. Our economy set a twenty year record for growth last quarter, and job creation is up. VCU graduates, your prospects are good.
Go pursue your dreams. You are now armed to do so. And remember, never stop learning.

Congratulations again to you, your families and your teachers. Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 15, 2003
JS-1055

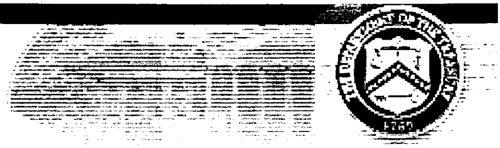
Treasury International Capital Data for October

Treasury International Capital (TIC) data for October is released today and posted on the U.S. Treasury web site (www.treas.gov/tic). The next release date, which will report on data for November, is scheduled for January 16, 2004.

According to the TIC data released today:

- Gross purchases by foreigners of U.S. long-term domestic securities from U.S. residents were $1,438 billion in October. Gross sales by foreigners of U.S. long-term domestic securities to U.S. residents were $1,397 billion in October.
- Thus, net foreign purchases of U.S. long-term domestic securities from U.S. residents were $41 billion in October, which compares with $16 billion in September.
- Net foreign purchases of U.S. Treasury notes and bonds from U.S. residents were $12 billion in October, which compares with $6 billion in September.
- Net foreign purchases of U.S. agency bonds from U.S. residents were $9 billion in October, which compares with -$3 billion in September.
- Net foreign purchases of U.S. corporate bonds from U.S. residents were $21 billion in October, which compares with $20 billion in September.
- Net foreign purchases of U.S. equities from U.S. residents were -$1 billion in October, which compares with -$6 billion in September.
- Net purchases by foreign official institutions of U.S. long-term domestic securities in October were $23 billion, up from $12 billion in September. Net purchases by foreign official institutions of U.S. Treasury notes and bonds were $19 billion, which compares with $8 billion in September.
- Gross purchases by foreigners of long-term foreign securities from U.S residents were $369 billion in October. Gross sales by foreigners of long-term foreign securities to U.S. residents were $382 billion in October.
- Thus, net foreign purchases of long-term foreign securities from U.S. residents were -$13 billion in October, which compares with -$12 billion in September.

For the full October data set, including adjustments for repayments of principal on asset-backed securities, as well as the historical series go to www.treas.gov/tic



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 15, 2003
2003-12-15-17-0-23-7138

Cost of Participation Report (FY 2003 Quarters)

See the attached Cost of Participation Report (FY 2003 Quarters) below:

Report(s):

- Cost of Participation Report (FY 2003 Quarters)

REPORT TO CONGRESS ON FINANCIAL IMPLICATIONS OF U.S. PARTICIPATION IN THE INTERNATIONAL MONETARY FUND

Fiscal Year 2003

This report has been prepared in compliance with Section 504(b) of Appendix E, Title V ofthe Consolidated Appropriations Act for FY 2000.[1] The report focuses exclusively on the financial implications of U.S. participation in the IMF and does not attempt to quantify the broad and substantial economic benefits to the United States and the global economy resulting from U.S. participation in the IMF.

As required, the report provides financial information on the net interest income and valuation changes associated with U.S. participation in the International Monetary Fund (IMF). The broader context for the financial implications OfU.S. participation in the IMF and the methodology used in deriving these figures have been laid out in previous reports. The methodology is also summarized briefly in the footnotes attached to the tables. Reports under this provision are prepared quarterly and made available to the public on the Treasury website: http://www.treas.gov/press/reports.html.

This report provides quarterly data for the fiscal year 2003. It provides information on U.S. participation in the IMF's General Department as well as information related to U.S. holdings of Special Drawing Rights (SDRs) as part of its international reserves and the financial implications of U.S. participation in the SDR Department of the IMF.[2]

Data on the net interest income and valuation changes related to U S. participation in the IMF's General Department during the fiscal year 2003 is provided in Table 1. For comparison purposes, previously-reported data for fiscal years 2000, 2001 and 2002 is also provided. (The data for these fiscal years reflects corrections to the information previously provided.)

Similarly, data for net interest income and valuation changes related to U.S. participation in the SDR Department of the IMF during the fiscal year 2003 is provided in Table 2. For comparison purposes, previously reported data for fiscal year 2002 is also provided.

The attached footnotes explain the columns shown on each table and provide pertinent information and assumptions used in the calculations.

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[1] Section 504(b) of Appendix E, Title V of the Consolidated Appropriations Act for FY 2000, Public Law 106-113, 113 Stat 1501A-317 requires that the Secretary ofthe Treasury prepare and transmit to the appropriate committees of the Congress a quarterly report on the costs or benefits of United States participation in the International Monetary Fund (IMF), detailing the costs or benefits to tlie United States, as well as valuation gains or losses on the United States' reserve position in the IMF

[2] The SDR is an international reserve asset created by tlie IMF The SDR is used as a unit of account by the IMF and other international organizations Its value is determined as a weighted average of a basket of currencies -- the dollar, euro, pound sterling and yen The SDR carries a market-based interest rate determined on the basis of a weighted average of interest rates on short-term instruments in tlie markets of the currencies included in the SDR valuation basket

As shown in Table 1, for fiscal year 2003, the financial implications of U S. participation in the General Department reflected a net interest income effect of $65 million, relative to $34 million, $7 million, and negative $43 million in fiscal years 2002, 2001 and 2000, respectively. The valuation change on the U.S. Reserve Position for fiscal year 2003 was $1.7 billion, which compares to $446 million, negative $47 million, and negative $1.1 billion in tlie prior three years.[3]

As shown in Table 2, for the fiscal year 2003, the net interest income effect of U S. participation in the SDR Department was $17 million, relative to $12 million in the prior period. The valuation change for fiscal year 2003 on U S. SDR holdings was $396 million, compared to $134 million in 2002.[4]

Attachments

[3] For an explanation of the methodology used in deriving these figures, see the section on "Calculating the Financial Implications of U.S. Participation in the General Department" in the report prepared for the fourth quarter of fiscal year 2000, submitted in December 2000 and available at http://www.treas.gov/press/releases/report3073.htm

[4] For an explanation of the methodology used in deriving these figures, see the section on "Calculating the Financial Implications of U.S. Participation in the SDR Department" in the report prepared for the fourth quarter of fiscal year 2000, submitted in December 2000 and available at http://www.treas.gov/press/releases/report3073.htm

Table 1

Net Interest Income and Valuation Changes Related to U.S. Participation in the IMF

-- General Account --

U.S. Fiscal Year, Quarterly

($M U.S. Dollars)

	Transactions with the IMF			Interest Calculations				Valuation	Total
Fiscal Year Ended 9/30	Transactions Under U.S. Quota (Letter of Credit &Transfers of Reserve Assets) Cumulative	U.S. Loans to IMF (Under SFF, GAB, NAB) Cumulative	Total U.S. Transactions with the IMF (Col 1+2)	Interest Expense Associated with Financing U.S. Transactions with the IMF	Remuneration Received by U.S. from IMF & Refund of Burden Sharing	Interest Received from IMF Under SFF, GAB, and NAB	Net Interest Income (Col. 4+5+6)	Valuation Changes on U.S. Reserve Position	Total (Col 7+8)
	Col. 1	Col. 2	Col. 3	Col. 4	Col.5	Col.6	Col. 7	Col. 8	Col. 9
2000									
Q1: Oct - Dec 99	-$14,263	$0	-$14,263	-$165	$147	$0	-$18	-$227	-$245
Q2: Jan - Mar 00	-14,484	0	-14,484	-171	148	0	-24	-316	-340
Q3: Apr - June 00	-12,161	0	-12,161	-146	144	0	-2	-115	-117
Q4: July - Sept 00	-10,864	0	-10,864	-139	139	0	0	-444	-444
Total				-$621	$578	$0	-$43	-$1,102	-$1,146
2001									
Q1: Oct - Dec 00	-$11,949	$0	-$11,949	-$138	$133	$0	-$5	$56	$51
Q2: Jan - Mar 01	-11,378	0	-11,378	-128	139	0	11	-474	-463
Q3: Apr - June 01	-12,389	0	-12,389	-109	115	0	5	-172	-167
Q4: July - Sept 01	-15,632	0	-15,632	-109	105	0	-4	543	539
Total				-$484	$492	$0	$7	-$47	-$40
2002									
Q1: Oct - Dec 01	-$15,547	$0	-$15,547	-$87	$105	$0	$18	-$467	-$449
Q2: Jan - Mar 02	-14,875	0	-14,875	-82	83	0	1	-125	-124
Q3: Apr - June 02	-16,500	0	-16,500	-80	81	0	1	1,157	1,158
Q4: July - Sept 02	-17,635	0	-17,635	-88	103	0	15	-119	-104
Total				-$337	$372	$0	$34	$446	$480
2003									
Q1: Oct - Dec 02	-$18,152	$0	-$18,152	-$79	$97	$0	$18	$580	$598
Q2: Jan - Mar 03	-18,826	0	-18,826	-72	91	0	19	234	253
Q3: Apr - June 03	-18,737	0	-18,737	-67	82	0	15	439	454
Q4: July - Sept 03	-19,136	0	-19,136	-65	78	0	13	469	482
Total				-$283	$348	$0	$65	$1,722	$1,787

Note: Detail may not add to total due to rounding.

TABLE 1
Footnotes to Columns

Column 1: Total cumulative transactions under the U.S. Quota, including drawings by the IMF under the Letter of Credit (75% portion of the U.S. quota) and the transfers of reserve assets to the IMF (generally 25% of the U.S. quota).

Column 2: Total cumulative dollar funding through loans to the IMF made by the U.S. under the Supplementary Financing Facility (SFF, in 1980), the General Arrangements to Borrow (GAB, in FY1998) and the New Arrangements to Borrow (NAB, in FY1999). All U.S. loans under the three facilities/arrangements have been repaid.

Column 3: Total cumulative U.S. transactions with the Fund (horizontal summation of columns 1 and 2).

Column 4: Total interest associated with total cumulative transactions shown in column 3. This includes interest paid on additional public borrowing to fund day-to-day transactions under the Letter of Credit and occasional transfers under loan arrangements (SFF, GAB, NAB), as well as interest income forgone due to the transfer of reserve assets to the IMF at the time of a quota increase. In order to provide resources under the Letter of Credit or under loan arrangements, the Treasury borrows from the public via additional issuance in the Treasury market; average cost of funds is used as a proxy for calculating the associated interest cost. This portion of the total interest paid enters the U.S. budget as interest on the public debt. For purposes of calculating forgone interest on the transfer of reserve assets to the IMF, the SDR interest rate is used.

Column 5: The U.S. earns interest on the non-gold portion of its reserve position in the IMF. This interest is called remuneration and, in combination with an adjustment by the IMF related to burden-sharing, is paid by the IMF every quarter. If remuneration is paid in SDRs, it is paid to the Exchange Stabilization Fund (ESF) and the ESF transfers the dollar equivalent to the Treasury General Fund. It is recorded in the budget as an offsetting receipt from the public. If the United States took payment in dollars (which it does not now do), the payment would be in the form of a decrease in the U.S. Letter of Credit and a counterpart increase in the U.S. reserve position.

Column 6: These amounts constitute the interest payments the United States has received on its loans to the IMF under the SFF, GAB, and NAB.

Column 7: Total net interest paid, forgone or received as a result of U.S. participation in the General Department of the IMF.

Column 8: The U.S. reserve position in the IMF is denominated in SDRs. The valuation gain (if positive) or loss (if negative) refers to the exchange rate gain or loss on the reserve position due to changes in the dollar value of the SDR. For example, if the SDR appreciates/dollar depreciates, then the dollar value of the reserve position rises and a valuation gain is recorded. This column would also include valuation gains or losses experienced as a result of U.S. loans under the SFF, GAB and NAB.

Column 9: The total of net interest and valuation changes, obtained by summing column 7 and column 8.

Table 2

Net Interest and Valuation Changes Related to U.S. Participation in the IMF

-- SDR Department --

U.S. Fiscal Year, Quarterly
($M U.S. Dollars)

	Net SDR Holdings			Interest Calculations			Valuation	Total
Fiscal Year Ended 9/30	Dollar Value of SDR Holdings	Dollar Value of Cumulative SDR Allocation	Net SDR Holdings (Col. 1 - Col. 2)	Interest Income on Net SDR Holdings	Interest Expense Associated with Financing Cumulative U.S. SDR Transactions	Net Interest Income (Col. 4 + Col. 5)	Valuation Changes	Total (Col. 6 + Col. 7)
	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8
2002								
Q1: Oct - Dec 01	$10,783	$6,157	$4,626	$26	-$25	$0	-$115	-$115
Q2: Jan - Mar 02	10,809	6,109	4,700	27	-24	4	-36	-32
Q3: Apr - June 02	11,645	6,519	5,127	30	-26	3	315	318
Q4: July - Sept 02	11,710	6,481	5,229	29	-24	4	-30	-26
Total				**$112**	**-$100**	**$12**	**$134**	**$145**
2003								
Q1: Oct - Dec 02	$12,166	$6,661	$5,505	$26	-$21	$5	$146	$151
Q2: Jan - Mar 03	11,392	6,731	4,662	20	-16	5	58	63
Q3: Apr - June 03	11,720	6,864	4,857	18	-15	3	92	95
Q4: July - Sept 03	12,062	7,005	5,057	20	-16	4	100	104
Total				**$84**	**-$68**	**$17**	**$396**	**$412**

Note: Detail may not add to total due to rounding.

TABLE 2
Footnotes to Columns

Column 1: Total stock of U.S. holdings of Special Drawing Rights (SDRs) measured at the end of period, converted into dollars at the end of period exchange rate. Source: IMF.

Column 2: Total stock of U.S. SDR allocations measured at the end of period, converted into dollars at the end of period exchange rate. Changes in dollar value of SDR allocations reflect only exchange rate changes. Source: IMF.

Column 3: Total stock of U.S. SDR holdings minus allocations measured from end of period (Column 1 minus Column 2), converted into dollars at the end of period exchange rate.

Column 4: Net interest earned on SDR holdings. Derived by subtracting charges on SDR allocations (the SDR end-of-quarter interest rate times SDR allocations) from interest earned on SDR holdings (the SDR end-of-quarter interest rate times SDR holdings). All interest is calculated as compounding quarterly.

Column 5: Net effect on U.S. borrowing costs due to cumulative net SDR purchases or sales, using the simplifying assumption that transactions are carried out in dollars. Derived by multiplying the dollar equivalent of cumulative net SDR purchases by the average cost of funds rate. Interest is calculated on the basis of end-quarter holdings and compounded quarterly.

Column 6: Net Interest (Column 4 plus 5).

Column 7: Derived by subtracting the change in total SDR holdings from the change in the dollar equivalent of total SDR holdings (end-period to end-period) divided by the end-period SDR/dollar exchange rate. The valuation gain (if positive) or loss (if negative) refers to the exchange rate gain or loss on the reserve position due to changes in the dollar value of the SDR. For example, if the SDR appreciates/dollar depreciates, then the impact on the dollar value of U.S. holdings of SDRs is positive, and a valuation gain is recorded.

Column 8: The total net interest and valuation changes (sum of Columns 6 and 7).

federal financing bank NEWS
WASHINGTON, D.C. 20220

FEDERAL FINANCING BANK

2003 PRESS RELEASE

December 2003

Brian Jackson, Chief Financial Officer, Federal Financing Bank (FFB) announced the following activity for the month of December 2003.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $30.8 billion on December 31, 2003, posting a decrease of $1,279.0 million from the level on November 30, 2003. This net change was the result of decreases in holdings of agency debt (U.S. Postal Service) of $1,137.6 million, in holdings of agency assets of $125.0 million, and in net holdings of government-guaranteed loans of $16.4 million. The FFB made 53 disbursements and received 14 prepayments during the month of December. The FFB also extended the maturities of 153 loans guaranteed by the Rural Utilities Service ("RUS") during the month.

Below are tables presenting FFB December 2003 loan activity and FFB holdings as of December 31, 2003.

FEDERAL FINANCING BANK
December 2003 ACTIVITY

JS - 1054A

Borrower	Date	Amount of Advance	Final Maturity	Interest Rate	Semi-Annual
AGENCY DEBT					
US POSTAL SERVICE					
U.S. Postal Service	12/1/03	$115,600,000.00	12/02/2003	1.091%	Semi-Annual
U.S. Postal Service	12/5/03	$388,600,000.00	12/8/2003	1.061%	Semi-Annual
U.S. Postal Service	12/8/03	$400,000,000.00	12/9/2003	1.061%	Semi-Annual
U.S. Postal Service	12/8/03	$183,400,000.00	12/09/2003	1.061%	Semi-Annual
U.S. Postal Service	12/9/03	$337,000,000.00	12/10/2003	1.051%	Semi-Annual
U.S. Postal Service	12/10/03	$165,300,000.00	12/11/2003	1.041%	Semi-Annual
GOVERNMENT-GUARANTEED LOANS					
GENERAL SERVICES ADMINISTRATION					
San Francisco OB	12/1/03	$142,051.38	8/1/2005	1.996%	Semi-Annual
Foley Square Office Bldg.	12/10/03	$549,153.00	7/31/2025	4.875%	Semi-Annual
San Francisco OB	12/11/03	$379,157.72	8/1/2005	1.857%	Semi-Annual
San Francisco Bldg Lease	12/12/03	$2,575,404.83	8/1/2005	1.755%	Semi-Annual
San Francisco Bldg Lease	12/16/03	$3,083,052.06	8/1/2005	1.799%	Semi-Annual
San Francisco OB	12/29/03	$127,897.58	8/1/2005	1.728%	Semi-Annual
DEPARTMENT OF EDUCATION					
Tuskegee Univ.	12/10/03	$1,388,497.96	1/2/2032	4.966%	Semi-Annual
Livingstone College	12/24/03	$263,248.71	7/1/2031	4.876%	Semi-Annual
Livingstone College	12/24/03	$57,125.00	7/1/2031	4.876%	Semi-Annual
Livingstone College	12/24/03	$34,563.05	7/1/2031	4.876%	Semi-Annual
Livingstone College	12/29/03	$151,948.41	7/1/2031	4.781%	Semi-Annual
Livingstone College	12/29/03	$53,834.59	7/1/2031	4.781%	Semi-Annual
RURAL UTILITIES SERVICE					
Grand Valley Rural #873	12/1/03	$1,038,000.00	12/31/2036	5.028%	Quarterly

S. Illinois Power #819	12/1/03	$7,299,000.00	12/31/2030	4.924%	Quarterly
Plateau Electric Coop. #881	12/2/03	$2,000,000.00	12/31/2036	5.074%	Quarterly
East Kentucky Power #2019	12/4/03	$27,000,000.00	1/3/2033	5.024%	Quarterly
Kenergy Corp. #2068	12/4/03	$6,000,000.00	3/31/2004	0.952%	Quarterly
New Horizon Elec. #791	12/4/03	$1,686,000.00	3/31/2004	0.953%	Quarterly
New Horizon Elec. #791	12/4/03	$1,034,000.00	3/31/2004	0.953%	Quarterly
Oglethorpe Power #2023	12/5/03	$3,296,000.00	12/31/2025	4.652%	Quarterly
Oglethorpe Power #2025	12/5/03	$13,190,000.00	12/31/2025	4.652%	Quarterly
Tri-County Elec. TN #2066	12/5/03	$5,032,000.00	1/3/2033	5.003%	Quarterly
Citizens Elec. #878	12/8/03	$4,000,000.00	12/31/2031	4.846%	Quarterly
Sangre De Cristo Elec. #732	12/8/03	$500,000.00	3/31/2011	3.739%	Quarterly
Belfalls Elec. #542	12/10/03	$640,000.00	1/3/2034	5.046%	Quarterly
West Florida Electric #2047	12/10/03	$2,103,000.00	12/31/2037	5.041%	Quarterly
Midstate Communications #780	12/11/03	$482,529.00	12/31/2018	4.203%	Quarterly
Wood County Electric #826	12/12/03	$1,500,000.00	12/31/2036	4.997%	Quarterly
Maquoketa Valley #2012	12/15/03	$1,200,000.00	12/31/2036	4.973%	Quarterly
Medina Electric #2050	12/15/03	$1,000,000.00	1/3/2005	1.307%	Quarterly
Interstate Tele #661	12/18/03	$1,213,000.00	12/31/2019	4.083%	Quarterly
Swan's Island Electric #203	12/20/03	$53,000.00	12/31/2036	4.847%	Quarterly
Virgin Islands Tel. #2089	12/20/03	$64,655,000.00	3/31/2004	0.893%	Quarterly
Adams Rural Electric #706	12/22/03	$644,000.00	3/31/2004	0.879%	Quarterly
Central Florida Elec. #521	12/22/03	$4,094,000.00	1/3/2033	4.775%	Quarterly
Fleming-Mason Energy #644	12/22/03	$3,000,000.00	3/31/2004	0.879%	Quarterly
Farmers Telephone #476	12/22/03	$5,404,520.00	3/31/2004	1.004%	Quarterly
Grayson Rural Elec. #619	12/22/03	$1,000,000.00	3/31/2004	0.879%	Quarterly
Butler County Rural Elec. # 832	12/23/03	$1,400,000.00	12/31/2036	4.873%	Quarterly
Darien Telephone Co. #719	12/23/03	$650,000.00	3/31/2004	0.911%	Quarterly
Coop. Power Assoc. #722	12/24/03	$6,100,000.00	1/2/2029	4.627%	Quarterly
REA Energy Cooperative #772	12/24/03	$2,500,000.00	12/31/2035	4.934%	Quarterly
S. Indiana Rural Elec. #205	12/24/03	$600,000.00	12/31/2037	4.966%	Quarterly
S. Illinois Power #2020	12/24/03	$12,203,000.00	1/3/2033	4.879%	Quarterly
United Power Assoc. #721	12/29/03	$5,700,000.00	12/31/2030	4.586%	Quarterly
Cornbelt Power #565	12/30/03	$510,000.00	1/3/2028	4.692%	Quarterly
Sangre De Cristo Elec. #732	12/30/03	$500,000.00	3/31/2009	3.257%	Quarterly

*Adams Rural Electric #706	12/31/03	$496,567.68	3/31/2004	0.937%	Quarterly
*Adams Rural Electric #706	12/31/03	$496,780.53	3/31/2004	0.937%	Quarterly
*Amicalola Electric #664	12/31/03	$4,842,712.13	3/31/2004	0.937%	Quarterly
*Amicalola Electric #664	12/31/03	$6,726,062.29	3/31/2004	0.937%	Quarterly
*Atlantic Telephone Mem. #80	12/31/03	$5,774,653.26	3/31/2004	0.937%	Quarterly
*Bailey County Elec. #856	12/31/03	$1,896,000.00	3/31/2004	0.937%	Quarterly
*Bailey County Elec. #856	12/31/03	$615,000.00	3/31/2004	0.937%	Quarterly
*Basin Electric #425	12/31/03	$12,577,017.90	3/31/2004	1.062%	Quarterly
*Basin Electric #2005	12/31/03	$3,000,000.00	3/31/2004	0.937%	Quarterly
*Big Sand Elec. #540	12/31/03	$753,357.83	3/31/2004	0.937%	Quarterly
*Big Sand Elec. #540	12/31/03	$565,018.37	3/31/2004	0.937%	Quarterly
*Big Sand Elec. #540	12/31/03	$944,588.02	3/31/2004	0.937%	Quarterly
*Big Sand Elec. #540	12/31/03	$2,196,862.83	3/31/2004	0.937%	Quarterly
*Big Sand Elec. #540	12/31/03	$2,744,378.19	3/31/2004	0.937%	Quarterly
*Blue Grass Energy #674	12/31/03	$1,935,851.16	3/31/2004	0.937%	Quarterly
*Blue Grass Energy #674	12/31/03	$4,932,953.81	3/31/2004	0.937%	Quarterly
*Brazos Electric #844	12/31/03	$4,432,000.00	3/31/2004	0.937%	Quarterly
*Brazos Electric #844	12/31/03	$5,000;000.00	3/31/2004	0.937%	Quarterly
*Brazos Electric #844	12/31/03	$5,000,000.00	3/31/2004	0.937%	Quarterly
*Brazos Electric #844	12/31/03	$5,000,000.00	3/31/2004	0.937%	Quarterly
*Brown County Elec. #687	12/31/03	$240,555.00	3/31/2004	0.937%	Quarterly
*Brown County Elec. #687	12/31/03	$577,332.03	3/31/2004	0.937%	Quarterly
*Brown County Elec. #687	12/31/03	$288,712.55	3/31/2004	0.937%	Quarterly
*Coast Elec. Power #787	12/31/03	$5,866,019.31	1/3/2005	1.282%	Quarterly
*Clark Energy Coop. #611	12/31/03	$2,833,764.04	3/31/2004	0.937%	Quarterly
*Clark Energy Coop. #611	12/31/03	$1,883,107.60	3/31/2004	0.937%	Quarterly
*Clark Energy Coop. #611	12/31/03	$4,202,525.54	3/31/2004	0.937%	Quarterly
*Clark Energy Coop. #611	12/31/03	$3,514,554.33	3/31/2004	0.937%	Quarterly
*Cumberland Valley $668	12/31/03	$2,545,747.35	3/31/2004	0.937%	Quarterly
*Cumberland Valley #668	12/31/03	$4,041,324.17	3/31/2004	0.937%	Quarterly
*Cooper Valley Tel. #648	12/31/03	$954,146.66	3/31/2004	0.937%	Quarterly
*Cooper Valley Tel. #648	12/31/03	$217,115.29	3/31/2004	0.937%	Quarterly
*Cotton Electric Coop #2038	12/31/03	$3,505,000.00	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$1,758,016.53	3/31/2004	4.989%	Quarterly
*Darien Telephone Co. #719	12/31/03	$404,979.83	3/31/2004	0.937%	Quarterly

*Darien Telephone Co. #719	12/31/03	$195,192.99	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$230,765.53	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$167,829.47	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$249,007.87	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$205,045.87	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$1,393,408.85	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$259,956.68	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$512,961.82	3/31/2004	0.937%	Quarterly
*Darien Telephone Co. #719	12/31/03	$373,632.52	3/31/2004	0.937%	Quarterly
*Delaware County Elec. #682	12/31/03	$635,152.90	3/31/2004	0.937%	Quarterly
*East River Power #453	12/31/03	$367,048.70	3/31/2004	1.062%	Quarterly
*East River Power #453	12/31/03	$181,017.24	3/31/2004	1.062%	Quarterly
*East River Power #601	12/31/03	$3,177,979.36	3/31/2004	0.937%	Quarterly
*East River Power #793	12/31/03	$620,148.47	3/31/2004	0.937%	Quarterly
*Fairfield Elec. #684	12/31/03	$3,111,567.66	3/31/2004	0.937%	Quarterly
*Farmer's Rural Elec. #2046	12/31/03	$5,000,000.00	3/31/2004	0.937%	Quarterly
*Farmer's Telephone #459	12/31/03	$20,706.73	3/31/2004	1.062%	Quarterly
*Farmer's Telephone #459	12/31/03	$197,238.01	3/31/2004	1.062%	Quarterly
*Federal Rural Elec. #728	12/31/03	$487,432.40	1/3/2005	1.282%	Quarterly
*Fleming-Mason Energy #644	12/31/03	$2,455,928.83	3/31/2004	0.937%	Quarterly
*Fleming-Mason Energy #644	12/31/03	$1,322,423.19	3/31/2004	0.937%	Quarterly
*Fleming-Mason Energy #644	12/31/03	$1,416,882.02	3/31/2004	0.937%	Quarterly
*Fleming-Mason Energy #644	12/31/03	$2,078,093.62	3/31/2004	0.937%	Quarterly
*Fleming-Mason Energy #644	12/31/03	$1,322,423.19	3/31/2004	0.937%	Quarterly
*Fleming-Mason Energy #644	12/31/03	$2,865,464.64	3/31/2004	0.937%	Quarterly
*Fleming-Mason Energy #644	12/31/03	$2,839,700.05	3/31/2004	0.937%	Quarterly
*Freeborn-Mower Coop. #736	12/31/03	$725,866.85	3/31/2004	0.937%	Quarterly
*Freeborn-Mower Coop. #736	12/31/03	$483,925.46	3/31/2004	0.937%	Quarterly
*Farmers Telephone #476	12/31/03	$9,344,327.19	3/31/2004	1.062%	Quarterly
*Farmers Telephone #476	12/31/03	$6,960,856.76	3/31/2004	1.062%	Quarterly
*FTC Communications #709	12/31/03	$2,487,490.86	3/31/2004	0.937%	Quarterly

*FTC Communications #709	12/31/03	$3;181;271.34	3/31/2004	0.937%	Quarterly
*Grady Electric #690	12/31/03	$3,062,953.31	3/31/2004	0.937%	Quarterly
*Grady Electric #746	12/31/03	$3,167,086.30	3/31/2004	0.937%	Quarterly
*Grayson Rural Elec. #619	12/31/03	$1,133,505.62	3/31/2004	0.937%	Quarterly
*Grayson Rural Elec. #619	12/31/03	$566,752.82	3/31/2004	0.937%	Quarterly
*Grayson Rural Elec. #619	12/31/03	$944,588.02	3/31/2004	0.937%	Quarterly
*Grayson Rural Elec. #619	12/31/03	$1,223,742.84	3/31/2004	0.937%	Quarterly
*Grayson Rural Elec. #619	12/31/03	$966,630.70	3/31/2004	0.937%	Quarterly
*Grayson Rural Elec. #619	12/31/03	$2,448,013.70	12/31/2030	4.695%	Quarterly
*Great River Energy #738	12/31/03	$13,290,810.82	12/31/2030	4.695%	Quarterly
*Great River Energy #738	12/31/03	$4,518,486.48	3/31/2004	0.937%	Quarterly
*Greenbelt Elec. #743	12/31/03	$1,705,217.25	3/31/2004	0.937%	Quarterly
*Greenbelt Elec. #743	12/31/03	$492,247.87	3/31/2004	0.937%	Quarterly
*Grundy Elec.Coop. #744	12/31/03	$1,218,110.12	3/31/2004	0.937%	Quarterly
*Grundy Elec.Coop. #744	12/31/03	$974,619.30	3/31/2004	0.937%	Quarterly
*Grundy Elec.Coop. #744	12/31/03	$496,700.88	3/31/2004	0.937%	Quarterly
*Harrison County #532	12/31/03	$940,746.66	3/31/2004	0.937%	Quarterly
*Harrison County #532	12/31/03	$846,672.01	3/31/2004	0.937%	Quarterly
*Harrison County #532	12/31/03	$947,093.57	3/31/2004	0.937%	Quarterly
*Harrison County #532	12/31/03	$1,544,388.09	3/31/2004	0.937%	Quarterly
*Harrison County #532	12/31/03	$1,662,722.20	3/31/2004	0.937%	Quarterly
*Hudson Valley Datanet #833	12/31/03	$5,000,000.00	3/31/2004	0.937%	Quarterly
*Hudson Valley Datanet #833	12/31/03	$2,000,000.00	3/31/2004	0.937%	Quarterly
*Inter-County Energy #592	12/31/03	$1,411,119.98	3/31/2004	0.937%	Quarterly
*Inter-County Energy #592	12/31/03	$1,881,493.33	3/31/2004	0.937%	Quarterly
*Inter-County Energy #592	12/31/03	$2,452,526.55	3/31/2004	0.937%	Quarterly
*Inter-County Energy #592	12/31/03	$208,753.94	3/31/2004	0.937%	Quarterly
*Inter-County Energy #850	12/31/03	$4,000,000.00	3/31/2004	0.937%	Quarterly
*Inter-County Energy #850	12/31/03	$2,000,000.00	3/31/2004	0.937%	Quarterly
*Ironton Telephone Co. #888	12/31/03	$3,235,942.00	6/30/2004	1.020%	Quarterly
*Ironton Telephone Co. #2051	12/31/03	$2,956,000.00	6/30/2004	1.020%	Quarterly
*Jackson Energy #794	12/31/03	$3,922,293.86	3/31/2004	0.937%	Quarterly
*Jackson Energy #794	12/31/03	$2,941,720.40	3/31/2004	0.937%	Quarterly
*Jackson Energy #794	12/31/03	$4,608,695.30	3/31/2004	0.937%	Quarterly

*Jackson Energy #794	12/31/03	$1,961,146.94	3/31/2004	0.937%	Quarterly
*Jackson Energy #794	12/31/03	$2,451,433.67	3/31/2004	0.937%	Quarterly
*Jackson Energy #794	12/31/03	$1,961,206.42	3/31/2004	0.937%	Quarterly
*Jackson Energy #794	12/31/03	$7,301,010.38	3/31/2004	0.937%	Quarterly
*Johnson County Elec. #482	12/31/03	$1,509,098.13	3/31/2004	1.062%	Quarterly
*Licking Valley Elec. #522	12/31/03	$2,586,112.57	3/31/2004	0.937%	Quarterly
*Licking Valley Elec. #854	12/31/03	$2,000,000.00	3/31/2004	0.937%	Quarterly
*Lynches River Elec. #634	12/31/03	$484,356.55	1/2/2007	2.372%	Quarterly
*Magnolia Electric #560	12/31/03	$4,711,164.57	3/31/2004	1.062%	Quarterly
*Medina Electric #622	12/31/03	$792,972.44	1/3/2005	1.282%	Quarterly
*North Carolina RSA3 Tel #2009	12/31/03	$9,600,000.00	3/31/2004	0.937%	Quarterly
*New Horizon Elec. #791	12/31/03	$2,035,236.97	3/31/2004	0.937%	Quarterly
*New Horizon Elec. #791	12/31/03	$1,376,333.80	3/31/2004	0.937%	Quarterly
*Nolin Rural Elec. #528	12/31/03	$1,780,833.41	3/31/2004	0.937%	Quarterly
*Nolin Rural Elec. #577	12/31/03	$2,429,948.65	3/31/2004	0.937%	Quarterly
*Nolin Rural Elec. #577	12/31/03	$2,429,948.65	3/31/2004	0.937%	Quarterly
*Nolin Rural Elec. #840	12/31/03	$4,000,000.00	3/31/2004	0.937%	Quarterly
*Nolin Rural Elec. #840	12/31/03	$2,948,000.00	3/31/2004	0.937%	Quarterly
*Northstar Technology #811	12/31/03	$1,781,983.55	3/31/2004	0.937%	Quarterly
*Northstar Technology #811	12/31/03	$971,906.92	3/31/2004	0.937%	Quarterly
*Owen Electric #525	12/31/03	$1,884,120.22	3/31/2004	0.937%	Quarterly
*Owen Electric #525	12/31/03	$1,880,315.20	3/31/2004	0.937%	Quarterly
*Owen Electric #525	12/31/03	$948,653.13	3/31/2004	0.937%	Quarterly
*Owen Electric #525	12/31/03	$1,913,066.30	3/31/2004	0.937%	Quarterly
*Owen Electric #525	12/31/03	$1,949,222.28	3/31/2004	0.937%	Quarterly
*Pataula Electric #585	12/31/03	$529,247.22	12/31/2008	3.203%	Quarterly
*Pennyrile Elec. #513	12/31/03	$5,760,426.43	3/31/2004	1.062%	Quarterly
*Pennyrile Elec. #513	12/31/03	$5,452,933.01	3/31/2004	1.062%	Quarterly
*Polar Telecommunications#2056	12/31/03	$1,346,000.00	1/3/2011	3.661%	Quarterly
*PRTCommunications #798	12/31/03	$4,723,423.58	3/31/2004	0.937%	Quarterly
*PRTCommunications #798	12/31/03	$1,770,546.12	3/31/2004	0.937%	Quarterly
*Runestone Electric Ass. #886	12/31/03	$1,500,000.00	3/31/2004	0.937%	Quarterly
*San Miguel Electric #919	12/31/03	$7,173,258.78	3/31/2004	0.937%	Quarterly
*San Miguel Electric #919	12/31/03	$7,532,005.66	3/31/2004	0.937%	Quarterly

*Scenic Rivers Energy #677	12/31/03	$1,342,526.62	1/2/2007	2.372%	Quarterly
*Socorro Elec. #869	12/31/03	$1,652,000.00	12/31/2036	4.973%	Quarterly
*Surry-Yadkin Elec. #534	12/31/03	$925,842.38	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #534	12/31/03	$925,842.38	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #534	12/31/03	$462,921.19	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #534	12/31/03	$925,842.38	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #534	12/31/03	$925,842.38	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #534	12/31/03	$941,022.09	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #534	12/31/03	$947,148.15	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #534	12/31/03	$2,187,998.42	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #852	12/31/03	$1,000,000.00	3/31/2004	0.937%	Quarterly
*Surry-Yadkin Elec. #852	12/31/03	$2,000,000.00	3/31/2004	0.937%	Quarterly
*Thumb Electric #767	12/31/03	$496,694.33	3/31/2004	0.937%	Quarterly
*Thumb Electric #767	12/31/03	$620,860.83	3/31/2004	0.937%	Quarterly
*United Elec. Coop. #870	12/31/03	$12,000,000.00	3/31/2004	0.937%	Quarterly
*United Elec. Coop. #870	12/31/03	$3,000,000.00	3/31/2004	0.937%	Quarterly
*Webster Electric #705	12/31/03	$2,136,915.05	3/31/2004	0.937%	Quarterly
*West Plains Elec. #501	12/31/03	$2,215,586.78	3/31/2004	1.062%	Quarterly

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FEDERAL FINANCING BANK HOLDINGS
December 2003
(in millions of dollars)

Program	*December 31, 2003*	*October 31, 2003*	*Monthly Net Change - 12/1/03 - 12/31/03*	*Fiscal Year Net Change 10/1/03- 12/31/03*
Agency Debt:				
U.S. Postal Service	$2.250.0	$3,387.60	($l 137.6)	($5,023.40)
Subtotal*	$2,250.00	$3,387.60	($l,137.6)	($5,023.40)
Agency Assets:				
FmHA-RDIF	$680.00	$805.00	($125.00)	($125.00)
FmHA-RHIF	$l,830.0	$1,830.00	$0.00	$0.00
Rural Utilities Service-CBO	$4,270.20	$4,270.20	$0.00	$0.0
Subtotal*	$6,780.20	$6,905.20	($125.00)	($125.00)
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	$1,634.90	$1,673.l	($38.20)	($53.50)
DoEd-HBCU+	$105.80	$103.90	$81.90	$26.50

DHUD-Comm.Dev.Block Grant	$l.1	$l.3	($0.20)	($l.0)
DHUD-Public Housing Notes	$l,054.8	$l,054.8	$0.00	($78.50)
General Svces Administration+	$2,142.60	$2,143.10	($0.50)	($4.60)
DOI-Virgin Islands	$9.60	$9.60	$0.00	$0.00
DON-Ship Lease Financing	$607.50	$607.50	$0.00	$0.00
Rural Utilities Service	$16,149.60	$16,127.20	$22.40	$531.30
SBA-State/Local Develop Cos.	$71.80	$73.60	($1.80)	($5.50)
DOT-Section 511	$3.00	$3.l	$0.00	$0.00
Subtotal*	$21,780.70	$21.797.l	($16.40)	$414.70
Grand total*	**$30,810.90**	**$32,089.90**	**($1,279.00)**	**($4,733.70)**

****figures may not total due to rounding; +does not include capitalized interest***

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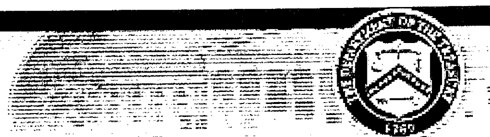
Last Updated on 1/22/03



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 16, 2003
JS-1056

Statement of Secretary John Snow on November Housing Starts and CPI

I am encouraged to see today's strong report on new residential construction. The continuing good performance of this sector is adding to the underlying fundamental strength of the economy. 2003 should be the best year for home building since 1978.

I am also encouraged by today's Consumer Price Index report, which underscores the potential for a long and sustainable recovery. We are continuing to see increased growth and job creation as the President's economic initiatives begin to take effect, but there is more yet to be done. We will continue our efforts until every American looking for work can find a job.

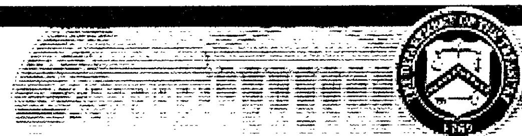
PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 16, 2003
JS-1057

Statement of
Acting Assistant Secretary for Economic Policy Mark Warshawsky
Regarding Industrial Production

Today's report on industrial production shows robust growth in our nation's factories. Manufacturing output increased 0.9 percent in November, the fastest rate of growth since 1999. The report confirms the improvement suggested by the ISM Manufacturing Index earlier this month. The gains in factory output were widespread, with increases in the production of both consumer goods and business equipment. High-tech production increased 4.1 percent and is up 27.5 percent versus last year. Although more remains to be done, today's data add to the evidence supporting the wisdom of the President's economic policies. Thanks to these policies, businesses have been upgrading their equipment at a rapid pace and the American economy has started creating jobs again.



FROM THE OFFICE OF PUBLIC AFFAIRS

December 16, 2003
2003-12-16-16-45-54-23030

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $86,558 million as of the end of that week, compared to $86,038 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*

	December 5, 2003			December 12, 2003		
TOTAL		86,038			86,558	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	8,113	14,594	22,707	8,211	14,601	22,812
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	13,265	2,932	16,197	13,408	2,933	16,341
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			23,863			24,043
3. Special Drawing Rights (SDRs) [2]			12,227			12,319
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	December 5, 2003			December 12, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0

2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:

2.a. Short positions	0	0
2.b. Long positions	0	0
3. Other	0	0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	December 5, 2003			December 12, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

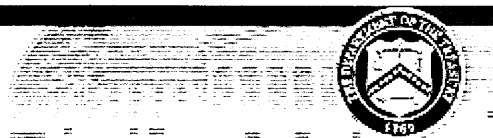
Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be subject to revision. IMF data for the prior week are final.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 18, 2003
JS-1059

Secretary John Snow Congratulates the U.S. Mint for Being Named the Top Federal Agency for Customer Service

I congratulate the United States Mint and Director Henrietta Holsman Fore for receiving the highest score of all Federal agencies in the University of Michigan Business School's 2003 American Customer Satisfaction Index. For eight years in a row, the U.S. Mint has been a leader among government agencies and the private sector in customer satisfaction by consistently offering its customers exciting new products and exemplary customers care. The dedicated public servants of the U.S. Mint have made their agency an example for all others to follow and I commend them for their hard work.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 18, 2003
JS-1060

OECD Reaches Agreement on Environmental Guidelines for Export Credit Agencies

Today, the Organization for Economic Cooperation and Development (OECD) gave its formal approval of an agreement that calls for member export credit agencies (ECAs) to evaluate the environmental impact of the projects that they are considering. The agreement lays out the procedures to be followed when performing an evaluation, and sets minimum environmental standards to be used.

"This agreement helps to create a level playing field for U.S. exporters," said John Taylor, Treasury Under Secretary for International Affairs. "It will help to ensure that projects receiving financing by export credit agencies will meet clear and transparent environmental standards."

The agreement marks the conclusion of several years of intensive negotiations among the members of this Paris-based multilateral organization, which has been at the center of this issue since the mid-1990s. The U.S. highlighted the need for ECA environmental guidelines by bringing the issue to the G-7 in 1997. In 1999, the G-7 and OECD Ministers both issued mandates for such work to begin. Negotiations were carried out in the OECD Trade Committee's Working Party on Export Credits and Credit Guarantees (ECG), which has competence for technical export credit issues.

In 2001, the ECG sought approval of a draft agreement which reflected substantial movement on the part of its members. However, the U.S. rejected it for failure to provide adequate assurances that appropriate environmental standards would be used, and for failing to provide basic transparency. The current agreement reflects significant progress in both areas.

The agreement also achieves a measure of consistency with MDB-supported projects, which have long been evaluated for their environmental impact and which are supported by the same shareholders comprising the OECD. In addition, the agreement is a significant step in leveling the playing field for U.S. exporters, who have had to comply with Ex-Im Bank's rigorous environmental guidelines since 1995.

The Department of the Treasury is the head of the U.S. delegation to the OECD and chief negotiator on all export credit issues. Treasury received strong support and active participation throughout the negotiations from the Department of State and the Ex-Im Bank, as well as the White House Council on Environmental Quality and the Environmental Protection Agency.

The following countries are members of the agreement: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United States, United Kingdom.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 22, 2003
JS-1061

Treasury Issues Guidance To Encourage Use Of New Innovative Health Savings Accounts (HSAs)

The Treasury Department and the Internal Revenue Service today issued guidance regarding the new and innovative Health Savings Accounts (HSAs). HSAs were created by the Medicare bill signed by President Bush on December 8th and are designed to help individuals save for qualified medical and retiree health expenses on a tax-free basis.

"Starting January 1, 2004, new innovative Health Savings Accounts will change the way millions can save to meet their health care needs," said Treasury Secretary John Snow. "We want Americans to be able to take advantage of HSAs as soon as possible," stated Treasury Secretary John Snow. "An HSA is a good deal, and all Americans should consider it. HSAs will help consumers have more choice in meeting their health care needs, and we are acting today to clear the way."

Any individual who is covered by a high-deductible health plan may establish an HSA. Amounts contributed to an HSA belong to individuals and are completely portable. Every year the money not spent would stay in the account and gain interest tax-free, just like an IRA. Unused amounts remain available for later years (unlike amounts in Flexible Spending Arrangements that are forfeited if not used by the end of the year). Tax-advantaged contributions can be made in three ways: the individual and family members can make tax deductible contributions to the HSA even if the individual does not itemize deductions, the individual's employer can make contributions that are not taxed to either the employer or the employee, and employers with cafeteria plans can allow employees to contribute untaxed salary through a salary reduction plan. Funds distributed from the HSA are not taxed if they are used to pay qualifying medical expenses. To encourage saving for health expenses after retirement, HSA owners between age 55 and 65 are allowed to make additional catch-up contributions ($500 in 2004) to their HSAs.

HSAs are more flexible and are available to many more individuals than Archer MSAs. The minimum required deductible of the high-deductible plan is lower, both employees and employers can contribute, and the maximum contribution is now the full amount of the deductible. Employees of large companies are now eligible. Individuals with existing MSAs can either retain them or roll the amounts over into a new HSA.

Today's guidance (Notice 2004-2) provides, in a question and answer format, information about what HSAs are, who can have HSAs, how to establish them and the basic rules for contributions and withdrawals from HSAs. While many of the rules follow previous guidance issued for Archer MSAs, they also address new issues specific to HSAs. In addition to the basic information about HSAs, the guidance provides the following clarifications:

- Employer contributions to employee HSAs are not subject to FICA taxes.
- An HSA is allowed for employees covered by an employer self-insured medical reimbursement plan with a qualifying high-deductible.
- Like MSAs, trustees or custodians are not required to determine if withdrawals are used for medical expenses.
- Special rules are provided for determining the deductible for high-deductible family coverage.
- Like MSAs, in addition to banks and insurance companies, persons may be approved as HSA custodians under the IRA nonbank trustee rules – and existing IRA or Archer MSA trustees or custodians are automatically approved.

- While an HSA trustee or custodian that does not sponsor the high-deductible health plan may request proof or certification that someone is eligible to contribute to the HSA, it is not required.
- Otherwise eligible individuals without earnings may contribute to an HSA – including self-employed and unemployed.

Treasury and the IRS intend to issue additional guidance in the summer of 2004. To that end, today's Notice requests comments concerning HSAs, including –

- What kinds of preventive care can be offered without a deductible in a high-deductible health plan?
- What is the relationship of HSAs to Flexible Spending Arrangements and Health Reimbursement Arrangements?
- Are high-deductible plans used in conjunction with an HSA allowed to impose a lifetime limit on benefits?

Treasury Assistant Secretary for Tax Policy Pam Olson stated, "We look forward to receiving comments from the public on the issues that need to be resolved in order to make HSAs a success."

Separately, the Federal Office of Personnel Management has already begun a review of HSAs and their role within the FEHB. OPM will identify opportunities to extend this new benefit to the 3.1 million members of the Federal team as they make decisions on how to spend their hard-earned dollars on healthcare.

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LINKS

- HSAs Technical Guidance
- HSAs Frequently Asked Questions
- HSAs Press Release

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 22, 2003
js-1062

Treasury Issues Capitalization Guidance

Today, the Treasury Department issued final regulations on capitalizing costs incurred in acquiring or creating intangible assets. The regulations generally follow the rules that were proposed in December of 2002 and in an advance notice of proposed rulemaking released in January of 2002.

The IRS also released today a notice informing taxpayers that the Treasury Department and the IRS intend to propose regulations that clarify the treatment of expenditures to repair, improve or rehabilitate tangible property. The notice identifies issues that the Treasury Department and the IRS may address in the proposed regulations and requests comments on the specific rules and principles that should be provided.

"In recent years, controversy regarding the capitalization of costs associated with tangible and intangible assets has consumed substantial IRS and taxpayer resources," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "The final regulations issued today provide clear and administrable rules that will provide certainty to taxpayers regarding the treatment of costs associated with intangible assets and will enable the IRS to fairly and efficiently administer the law. The notice begins the process of providing similar certainty regarding the treatment of costs associated with tangible assets."

To clarify the application of section 263(a) of the Internal Revenue Code, the final regulations describe specific categories of expenditures incurred in acquiring or creating intangible assets that taxpayers are required to capitalize. The final regulations also describe certain types of enhancements to intangible assets that are required to be capitalized. Expenditures incurred in acquiring, creating, or enhancing intangible assets that are not described in the final regulations are not required to be capitalized under section 263(a); however, another provision of the Code may require that the capitalization of these expenditures.

The final regulations provide safe harbors and simplifying assumptions that permit the current deduction of certain costs and reduce taxpayers' record-keeping burden including a “12 month” rule for costs of certain intangible assets with relatively short useful lives, “de minimis” rules for costs less than a specified dollar amount, an employee compensation rule, and an overhead rule. In addition, the final regulations permit a 15-year safe harbor amortization period for certain created intangible assets that do not have a readily ascertainable useful life.

The Treasury Department and IRS plan to address in future guidance the treatment of costs related to the development and implementation of computer software and costs required to be capitalized in certain transactions including tax-free acquisitive transactions and stock issuance transactions.

The text of the Final Regulations and the Advance Notice of Proposed Rulemaking are attached. They will be published in the Federal Register in the next few days and are subject to minor technical changes.

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Related Documents:

- Final Regs
- Notice

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD]

RIN 1545-BA00

Guidance Regarding Deduction and Capitalization of Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that explain how section 263(a) of the Internal Revenue Code (Code) applies to amounts paid to acquire or create intangibles. This document also contains final regulations under section 167 of the Code that provide safe harbor amortization for certain intangibles, and final regulations under section 446 of the Code that explain the manner in which taxpayers may deduct debt issuance costs.

DATES: Effective Date: These regulations are effective **[INSERT DATE OF FILING OF THIS DOCUMENT WITH THE FEDERAL REGISTER].**

Applicability Dates: For dates of applicability of the final regulations, see §§1.167(a)-3(b)(4), 1.263(a)-4(o), 1.263(a)-5(m), and 1.446-5(d).

FOR FURTHER INFORMATION CONTACT: Andrew J. Keyso, (202) 622-4800 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

113 pp.

Part III --- Administrative, Miscellaneous, and Procedural

Weighted Average Interest Rate Modification

Notice 2004-34

This notice provides guidance as to the determination of the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the additional funding requirements under § 412(l) of the Internal Revenue Code and the minimum full funding limitation of § 412(c)(7)(E) of the Code, the corresponding requirements and limitation under §§ 302(c)(7)(E) and 302(d) of the Employee Retirement Income Security Act of 1974 (ERISA). In addition, this notice sets forth the interest rate under § 4006(a)(3)(E)(iii)(V) of ERISA, which is needed in the determination of unfunded vested benefits for purposes of determining premiums payable to the Pension Benefit Guaranty Corporation (PBGC). This notice implements changes to the rules regarding those interest rates that were enacted in section 101 of the Pension Funding Equity Act of 2004, P.L. 108-___.

BACKGROUND AND PRIOR LAW

Under § 412(b)(5)(A) of the Code, the funding standard account (and items therein) must be charged or credited with interest at the appropriate rate consistent with the rate or rates of interest used under the plan to determine costs.

Section 412(b)(5)(B) provides special rules for the interest rate that is used to determine a plan's current liability for purposes of § 412(l) and for purposes of the minimum full funding limitation under § 412(c)(7)(E). In general, that interest rate must fall within a specified corridor based on the weighted average of the rates of interest on 30-year Treasury constant maturities during the 4-year period ending on the last day before the beginning of the plan year, as published monthly in the Internal Revenue Bulletin. See Notice 88-73 (1988-2 C.B. 383). Under Notice 2002-26 (2002-1 C.B. 743), the interest rate used in determining the weighted average interest rate currently is based on the yield on the 30-year Treasury bonds maturing in February 2031.

In general, § 412(l)(7)(C)(i)(II) specifies that, for years after 1998, the interest rate used to determine the deficit reduction contribution must be not more than 105% of the weighted average interest rate. A special rule for 2002 and 2003 was enacted in the Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147, 116 Stat. 21) to provide for the deficit reduction contribution under § 412(l) to be calculated using a corridor capped at 120% of the weighted average interest rate rather than 105% of the weighted average interest rate.

PENSION FUNDING EQUITY ACT OF 2004

The Pension Funding Equity Act was enacted on April 10, 2004. Section 412(b)(5)(B)(ii)(III) of the Code, which was added by section 101 of the Pension Funding Equity Act, provides that, for plan years beginning in 2004 and 2005, the interest rate used to determine current liability must not be above and must not be more than 10 percent below 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. Under § 412(b)(5)(B)(ii)(III), the Treasury Department must prescribe a method for periodically determining the rates. These rates must be based on the use of two or more indices that are in the top three quality levels available. The Treasury Department must make the permissible range, and the indices and methodology used to determine the average rate, publicly available.

Section 412(l)(7)(C)(i)(IV), which was also added by the Pension Funding Equity Act, provides that, for plan years beginning in 2004 and 2005, the interest rate used to determine current liability for purposes of determining the deficit reduction contribution must be the same as the rate used under § 412(b)(5).

INTERIM GUIDANCE

This notice provides interim guidance on the determination of the weighted average interest rate under § 412(b)(5)(B)(ii)(III) of the Code and § 302(b)(5)(B)(ii)(III) of ERISA. In addition, this notice provides interim guidance as to the interest rate under § 4006(a)(3)(E)(iii)(V) of ERISA, which is needed in the determination of unfunded vested benefits for purposes of determining premiums payable to the PBGC. Taxpayers can rely on this interim guidance until the publication of further guidance. Any further guidance will not apply to plan years beginning before the publication of further guidance. The determination of the weighted average involves: a specification of the indices; the determination of the rate of interest on amounts invested conservatively in investment-grade corporate bonds (the "composite corporate bond rate"); and the determination of a 4-year weighted moving average of the composite corporate bond rate (the "corporate weighted average interest rate").

Specification of Indices

The following indices are designated for use in determining composite corporate bond rates beginning with January 1997 and ending August 2000.

1. Citigroup High Grade Corporate Index (AAA/AA, 10+ Years)
2. Merrill Lynch US Corporates AA-AAA Rated 10+ Years
3. Merrill Lynch US Corporates A Rated 15+ Years

The following indices are designated for use in determining the composite corporate bond rates beginning with September 2000 and continuing until further guidance is issued:

1. Citigroup High Grade Credit Index[1] (AAA/AA, 10+ Years)
2. Merrill Lynch US Corporates AA-AAA Rated 10+ Years
3. Lehman Brothers US A Long Credit

All of these indices reflect interest rates on long-term corporate bonds that are in the top three quality levels.

Composite Corporate Bond Rate

The composite corporate bond rate for a month is determined using the indices

[1] The name of the Citigroup High Grade Corporate Index was changed to the Citigroup High Grade Credit Index in April 2001, when a new Citigroup High Grade Corporate Index was created.

designated in this notice. For each index designated for inclusion in determining the composite corporate bond rate for a month, a monthly rate is determined based on the average of the daily values for the yield to maturity for the bonds that are included in the index, as determined by the financial service firm maintaining the index. The composite corporate bond rate for the month is determined by computing the average of these monthly rates. Table 1 lists the composite corporate bond rates for the months January 2000 through March 2004.

Corporate Weighted Average Interest Rate and Section 412(b)(5)(B)(ii)(III) Permissible Range

The corporate weighted average interest rate under § 412(b)(5)(B)(ii)(III) for a month is determined by applying the weighting methodology set forth in Notice 88-73 to the composite corporate bond rates for the 48 months preceding that month. Thus, in determining the 48-month weighted average of the composite corporate bond rate, the composite corporate bond rate for each of the months within the immediately preceding 12 months receives a weight of 4, those that are 13-24 months in the past receive a weight of 3, those that are 25-36 months in the past receive a weight of 2 and those that are 37 or more months before the determination receive a weight of 1. The § 412(b)(5)(B)(ii)(III) permissible range is 90% to 100% of the corporate weighted average interest rate. Table 2 lists the corporate weighted average interest rates and the permissible range for plan years beginning in the months January 2001 through April 2004.

Lookback Rules

Under section 101(d)(2) of the Pension Funding Equity Act of 2004, for purposes of applying section 412(l)(9)(B)(ii) and section 412(m)(1) of the Code (and section 302(d)(9)(B)(ii) and section 302(m)(1) of ERISA) to plan years beginning after December 31, 2003, the amendments made by section 101 of the Pension Funding Equity Act of 2004 may be applied as if such amendments have been in effect for all prior years. Thus, for example, for the plan year beginning January 1, 2004, in determining whether the plan's funded current liability percentage was at least 90 percent for two consecutive years of the previous three years under section 412(l)(9)(B)(ii), the funded current liability percentage may be recalculated using the corporate weighted average interest rate applicable for plan years beginning in January 2001, 2002, and 2003. Similarly, in determining whether a plan is subject to quarterly contributions under section 412(m)(1) for the plan year beginning January 1, 2004, the funded current liability percentage for 2003 may be recalculated using the corporate weighted average interest rate.

However, for purposes of computing the required installment under section 412(m)(4) for plan years beginning in 2004, the required amount for plan years beginning in 2003 may not be recalculated using the corporate weighted average interest rate. Instead, the required amount for 2003 will continue to be determined based upon an interest rate which is within the range of 90 to 120 percent of the weighted average of the rate of interest on 30-year Treasury securities.

Monthly Publication of Rates

The IRS will publish by notice each month the composite corporate bond rate, the corporate weighted average interest rate, and the § 412(b)(5)(B)(ii)(III) permissible range. The same notice will specify a change in the group of indices that are taken into account in determining the component corporate bond rate, and the manner they are taken into account, if any such change takes place.

Request for Comments

Comments are requested regarding the determination of the composite corporate bond rate set forth in this notice. Specifically, comments are requested regarding the appropriateness of the indices that are used in the determination of this rate, whether other indices would be more appropriate for this purpose, and the appropriateness of the weight given to each index.

Comments should be submitted by August 2, 2004, to CC:PA:LPD:RU (Notice 2004-34), Room 5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m., Monday through Friday to CC:PA:LPD:RU (Notice 2004-34), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave. NW, Washington D.C. Alternatively, comments may be submitted electronically via e-mail to the following address: Notice.Comments@irscounsel.treas.gov, with "Notice 2004-34" in the subject line. All comments will be available for public inspection.

Drafting Information

The principal author of this notice is 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 1-877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Montanaro may be reached at 1-202-283-9714 (not a toll-free number).

Table 1
Composite Corporate Bond Rates

	Composite Rates for:				
Month	**2000**	**2001**	**2002**	**2003**	**2004**
January	7.94	7.34	6.92	6.07	5.68
February	7.84	7.21	6.86	5.90	5.63
March	7.87	7.08	7.10	5.89	5.44
April	7.84	7.28	7.03	5.91	
May	8.27	7.28	6.99	5.42	
June	8.05	7.17	6.76	5.24	
July	7.93	7.13	6.74	5.77	
August	7.82	6.95	6.57	6.19	
September	7.87	7.05	6.27	5.95	
October	7.85	6.91	6.47	5.91	
November	7.82	6.82	6.30	5.86	
December	7.51	7.07	6.18	5.81	

Table 2
Corporate Bond Weighted Average Interest Rates

For Plan Years Beginning in: Year	Month	Corporate Bond Weighted Average	Permissible Range 90 %	100 %
2001	January	7.44	6.69	7.44
2001	February	7.44	6.69	7.44
2001	March	7.44	6.69	7.44
2001	April	7.43	6.68	7.43
2001	May	7.42	6.68	7.42
2001	June	7.42	6.68	7.42
2001	July	7.41	6.67	7.41
2001	August	7.40	6.66	7.40
2001	September	7.39	6.65	7.39
2001	October	7.37	6.64	7.37
2001	November	7.36	6.62	7.36
2001	December	7.34	6.61	7.34
2002	January	7.34	6.60	7.34
2002	February	7.33	6.60	7.33
2002	March	7.32	6.59	7.32
2002	April	7.32	6.58	7.32
2002	May	7.31	6.58	7.31
2002	June	7.30	6.57	7.30
2002	July	7.28	6.55	7.28
2002	August	7.26	6.53	7.26
2002	September	7.23	6.51	7.23
2002	October	7.20	6.48	7.20
2002	November	7.17	6.46	7.17
2002	December	7.14	6.43	7.14
2003	January	7.11	6.40	7.11
2003	February	7.07	6.36	7.07
2003	March	7.03	6.33	7.03
2003	April	6.98	6.29	6.98
2003	May	6.94	6.25	6.94

2003	June	6.87	6.19	6.87
2003	July	6.80	6.12	6.80
2003	August	6.75	6.08	6.75
2003	September	6.72	6.05	6.72
2003	October	6.68	6.01	6.68
2003	November	6.63	5.97	6.63
2003	December	6.59	5.93	6.59
2004	January	6.55	5.89	6.55
2004	February	6.50	5.85	6.50
2004	March	6.45	5.81	6.45
2004	April	6.40	5.76	6.40

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 22, 2003
js-1063

Treasury Urges UN to Designate Terrorist Organizations Avoiding International Sanctions

Today, the United States and Saudi Arabian governments are asking the UN 1267 Sanctions Committee to list Vazir, a non-governmental organization located in Travnik, Bosnia, as an aka for Al Haramain-Bosnia. In addition, we are asking the Committee to add Safet Durguti, the representative of this organization, to their list of persons and entities tied to al-Qaida, subject to international sanctions under UNSCRs 1256, 1333, and 1390.

In addition, the United States is designating Hochburg AG as an aka for BA Taqwa. BA Taqwa was designated by the U.S. and added to the UN 1267 Sanctions Committee in 2002 because Youssef Nada, a Specially Designated Global Terrorist, had a controlling interest in BA Taqwa. Nada maintains an ongoing interest in the liquidation of Hochburg.

"These designations signal that we continue to track terrorist targets and designated persons who attempt to evade the international sanctions regime," stated Deputy Assistant Secretary for Terrorist Financing Juan Zarate. "It further indicates that international cooperation on all fronts is a necessary and ongoing component of the long-term campaign against terrorist financing."

BACKGROUND INFORMATION

Vazir/Durguti

On March 13, 2002, the UN 1267 Sanctions Committee listed the Bosnian branch of Al Haramain, a Saudi-based charity, as an organization with ties to al-Qaida, subject to sanctions under UNSCRs 1267, 1333, and 1390. This branch office was submitted to the UN 1267 Sanctions Committee jointly by the United States and the government of Saudi Arabia. (The U.S. Government designated Al-Haramain-Sarajevo, Bosnia for asset-freeze pursuant to U.S. Executive Order 13224 on March 11, 2002.)

The U.S. Government has information establishing that Al Haramain resumed operation in Travnik, Bosnia under a new name, Vazir. After the Bosnia branch of Al Haramain was designated in March 2002, Al Haramain officials closed its Bosnian operations. Officials in Bosnia, persuaded senior Al Haramain officials to reopen the organization under a different name in Travnik, Bosnia.

The new non-governmental organization, Vazir, was founded in May 2003, and its leadership and mandates have been established since that time. Vazir established its headquarters in a business space formerly used by Al Haramain. The Ministry of Justice and Administration for the Central Bosnian canton registered Vazir on June 11, 2003, as an association for sport, culture, and education. The office opened under the name Vazir in early August 2003.

Safet Durguti was appointed as the representative of Vazir. The Al

Haramain and Vazir legal, banking and registration documentation all have Durguti's involvement in common. Durguti re-opened the Vazir office in the same location as the former office of Al Haramain.

Hochburg

Hochburg, AG ("Hochburg"), located in Vaduz, Liechtenstein, is the successor organization to BA Taqwa for Commerce and Real Estate Company Limited ("BA Taqwa"), an entity previously named a Specially Designated Global Terrorist ("SDGT") on August 29, 2002 by the U.S. Department of the Treasury. The UN 1267 Sanctions Committee added BA Taqwa to its consolidated asset-freeze list on September 3, 2002.

The official corporate registry of Liechtenstein indicates that BA Taqwa (registration number 245/15) was renamed Hochburg AG on January 28, 2002.

Youssef Nada, an SDGT whose controlling interest in BA Taqwa resulted in its initial designation, maintains an ongoing interest in the liquidation of Hochburg. Nada was one of two liquidators for the company as of June 2, 2002. Nada was designated an SDGT on November 6, 2001. [Note: Liechtenstein has since removed Nada from his position as liquidator of Hochburg.]

Hochburg and BA Taqwa share the same business registration number. Publicly available commercial reporting substantiates Hochburg's status as BA Taqwa's successor. This reporting lists Nada as one of the liquidators of Hochburg and provides a business registration number identical to that of BA Taqwa (245/15).

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 22, 2003
js-1064

Treasury Issues Final Research Credit Regulations

Today the Treasury Department and the IRS issued final regulations for the research credit. These regulations provide rules for determining which research activities are eligible for the credit. The Treasury Department and the IRS also issued a notice requesting additional comments on the proposed rules for internal-use software.

"These regulations are an important step towards resolving the uncertainty that has surrounded the research credit. They provide clearer rules to make it less burdensome for taxpayers to claim the credit and easier for the IRS to administer," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "At the same time, the regulations are flexible enough to address the wide range of research activities being conducted in the U.S. today. They will help ensure that the credit continues to serve its purpose of supporting research conducted in the U.S."

The regulations issued today replace regulations that were issued in January 2001. Shortly after the January 2001 regulations were issued, the Treasury Department and the IRS began a review of those regulations and solicited additional public comments. Consistent with the regulations proposed in December 2001, today's final regulations reflect significant changes to the provisions relating to the statutory requirement that qualifying research be "undertaken for the purpose of discovering information which is technological in nature." In addition, the regulations provide additional guidance regarding the statutory requirement that qualifying research constitute a "process of experimentation."

Treasury and IRS did not finalize today the rules relating to software that is developed by a taxpayer primarily for the taxpayer's internal use, often referred to as internal-use software. To qualify for the research credit, internal-use software must satisfy additional requirements. Since 1997, the Treasury Department and the IRS have issued a series of proposed and final regulations addressing both the definition of internal-use software and the additional qualification requirements for internal-use software. The Treasury Department and the IRS have concluded that additional public comments would be useful before the internal-use software rules are finalized. Consequently, the Treasury Department and the IRS are requesting additional public comments to ensure that final rules address comprehensively all issues raised by internal-use software.

"The world has changed significantly since the statutory provision for internal-use software was enacted in 1986," Assistant Secretary Olson continued. "A number of important issues still must be resolved before we can issue final regulations that both carry out the statute's purpose and provide clear and meaningful rules for software development today. Although our goal was to finalize regulations for all aspects of the research credit this year, it is more important for us to have the rules right. Consequently, we are requesting further input from the public on internal-use software before we move forward."

The public is invited to submit comments concerning a definition of internal-use software that appropriately reflects the statute and legislative history, can be readily applied by taxpayers and readily administered by the IRS,

and is flexible enough to provide continuing application into the future. The notice states that while the Treasury Department and the IRS are considering these comments, taxpayers may rely on either the final regulations issued in January 2001 or the proposed regulations issued in December 2001 for rules for internal-use software. The Notice requests commentators to address whether final regulations for internal-use software should have any retroactive effect.

The Treasury Department and the IRS believe that today's guidance on the research credit will facilitate the resolution of a number of contentious issues that have consumed considerable taxpayer and IRS resources. The Treasury and the IRS expect that the final regulations will provide taxpayers and the IRS an opportunity to resolve disputes over the research credit in a timely manner. This will allow the IRS to devote compliance resources to more productive areas.

The texts of the final regulations and the advanced notice of proposed rulemaking are attached. They will be published in the Federal Register in the next few days and are subject to minor technical changes.

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Related Documents:

- Final Regulations
- Advanced Notice of Proposed Rulemaking

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-112991-01]

RIN 1545-AY82

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definition of qualified research under section 41(d) for the credit for increasing research activities. These final regulations reflect changes to section 41(d) made by the Tax Reform Act of 1986.

DATES: Effective Dates: These regulations are effective **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability of these regulations, see Effective Dates under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Nicole R. Cimino at (202) 622-3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 2, 1998, the Treasury Department and the IRS published in the **Federal Register** (63 FR 66503) a notice of proposed rulemaking (REG-10570-97, 1998-2 C.B. 729) under section 41 (1998 proposed regulations) relating to the credit for increasing research activities (research credit). The 1998 proposed regulations addressed, in relevant part, (1) the definition of qualified research under section 41(d), (2) the application of the exclusions from the definition of qualified research, and (3) the application of the shrinking-back rule. Comments responding to the 1998 proposed regulations were received and a public hearing was held on April 29, 1999.

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 280) final regulations relating, in relevant part, to the definition of qualified research under section 41(d) (TD 8930). In response to taxpayer concerns regarding TD 8930, on January 31, 2001, the Treasury Department and the IRS published Notice 2001-19 (2001-10 I.R.B. 784), announcing that the Treasury Department and the IRS would review TD 8930 and reconsider comments previously submitted in connection with the finalization of TD 8930. Notice 2001-19 also provided that, upon the completion of the review, the Treasury Department and the IRS would announce changes to the regulations, if any, in the form of

proposed regulations.

On December 26, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 66362) a notice of proposed rulemaking (REG-112991-01) reflecting the Treasury Department and the IRS' review of TD 8930 (2001 proposed regulations). Comments responding to the 2001 proposed regulations were received and a public hearing was held on March 27, 2002. After considering the comments received and the statements made at the public hearing, portions of the 2001 proposed regulations are adopted as revised by this Treasury Decision.

Explanation of Provisions

This document amends 26 CFR part 1 to provide revised rules for the research credit under section 41. These final regulations generally retain the provisions of the 2001 proposed regulations but clarify the provisions relating to the requirement in section 41(d)(1)(C) that qualified research be research "substantially all of the activities of which constitute elements of a process of experimentation." These final regulations, however, do not contain final rules for research with respect to computer software "which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" for purposes of section 41(d)(4)(E).

Process of Experimentation -- In General

The Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085)(the 1986 Act), which narrowed the definition of the term qualified research, amended the definition of qualified research by adding a process of experimentation requirement. Section 41(d)(1) provides that in order to constitute qualified research, substantially all of the activities of the research must constitute elements of a process of experimentation related to a new or improved function, performance, or reliability or quality. The legislative history to the 1986 Act explained that "[t]he determination of whether research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science." H.R. Conf. Rep. No. 99-841, at II-71 (1986). The legislative history further explained that the term process of experimentation means, "a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset." Id., at II-72. In addition, a process of experimentation may involve developing one or more hypotheses,

testing and analyzing those hypotheses (through, for example, modeling or simulation), and refining or discarding the hypotheses as part of a sequential design process to develop the
overall component. Id.

The 1998 proposed regulations defined a process of experimentation as "a process to evaluate more than one alternative designed to achieve a result where the means of achieving that result are uncertain at the outset." Further, the 1998 proposed regulations specified that a process of experimentation is a four-step process requiring that the taxpayer: (i) develop one or more hypotheses designed to achieve the intended result; (ii) design a scientific experiment (that, where appropriate to the particular field of research, is intended to be replicable with an established experimental control) to test and analyze those hypotheses (through, for example, modeling, simulation, or a systematic trial and error methodology); (iii) conduct the experiment and record the results; and (iv) refine or discard the hypotheses as part of a sequential design process to develop or improve the business component. Commentators generally objected to this prescribed four-step test arguing that it would not be appropriate for evaluating the qualification of certain

commercial and industrial research activities.

In response to these comments, the Treasury Department and the IRS in TD 8930 provided that taxpayers conducting a process of experimentation may, but were not required to, engage in the four-step process described in the 1998 proposed regulations, but eliminated, for this purpose, the specific recordation requirement. (As an addition to the general recordkeeping requirement under section 6001, TD 8930 instead included a contemporaneous documentation requirement that was intended to be less burdensome than the specific recordation requirement. The contemporaneous documentation requirement in TD 8930 was eliminated in the 2001 proposed regulations.) Consistent with the legislative history, however, TD 8930 retained the underlying process of experimentation requirement in the 1998 proposed regulations by providing that a process of experimentation "is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset."

The 2001 proposed regulations further clarified the definition of a process of experimentation and provided, in relevant part, that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a

result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities." More specifically, however, the general requirement was modified in the 2001 proposed regulations to provide, first, that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result." (Emphasis added). The 2001 proposed regulations also provided that a process of experimentation may exist if a taxpayer performs research to establish the appropriate design of a business component even when the capability and method for developing or improving the business component are not uncertain. The 2001 proposed regulations further stated that a taxpayer's activities do not constitute elements of a process of experimentation where the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are readily discernible and applicable as of the beginning of the taxpayer's research activities so that true experimentation in the scientific or laboratory sense would not have to be undertaken to test, analyze, and choose among viable alternatives. Finally, the 2001 proposed regulations emphasized that the determination of whether a taxpayer has

engaged in a process of experimentation was dependent on the facts and circumstances of the taxpayer's research activities and, for this purpose, contained three non-dispositive and non-exclusive factors that tend to indicate that a taxpayer has engaged in a process of experimentation.

In response to the 2001 proposed regulations, a number of commentators expressed concern with the rules for the process of experimentation requirement, and, in particular, stated that the rules and terms used (including uncertainty, appropriate design, and readily discernible and applicable) did not provide clear guidance for the requirement. More specifically, commentators stated that the term readily discernible and applicable was highly subjective in nature, and thus arguably could be construed as a variant of the discovery test of TD 8930. In addition, one commentator expressed concern regarding the meaning and scope of the term uncertain and suggested adding examples illustrating the factors that tend to indicate that a taxpayer has engaged in a process of experimentation. Another commentator also noted that the 2001 proposed regulations appeared to allow the inclusion of all design costs as qualified research expenditures to the extent that the appropriate design of the desired result is never certain at the outset of the typical

design process.

The Treasury Department and the IRS continue to believe that the process of experimentation test requires an evaluation of the facts and circumstances of a taxpayer's research activities. As reflected by the changes made in the 2001 proposed regulations, this requirement is not intended to be inflexible or overly narrow. Nevertheless, the Treasury Department and the IRS continue to believe that the requirement in the 2001 proposed regulations that a process of experimentation is "a process designed to evaluate one or more alternatives to achieve a result" (emphasis added) implies that research activities must contain certain core elements in order to constitute a process of experimentation within the meaning of section 41(d)(1)(C). These final regulations, therefore, make the following clarifications relating to the process of experimentation requirement in the 2001 proposed regulations.

Process of experimentation -- requirements

The final regulations retain, but further clarify, the requirement in the 2001 proposed regulations that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design

of that result, is uncertain as of the beginning of the taxpayer's research activities." Further, the final regulations emphasize that the taxpayer's activities must be directed at resolving uncertainty regarding the taxpayer's development or improvement of a business component, and that the process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science in attempting to resolve the uncertainty. Although these concepts are stated explicitly in the 1986 legislative history and are implicit in the statute, they may not have been given appropriate or necessary weight in prior proposed or final guidance on the process of experimentation requirement.

The final regulations, therefore, set out what the Treasury Department and the IRS have concluded to be the core elements of a process of experimentation for purposes of the research credit. As noted above and consistent with the statute's wording which requires purposeful activity (i.e., "undertaken for the purpose of discovering information"), a taxpayer is required to identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer's research activities. A taxpayer is also required to identify one or more alternatives intended to

eliminate that uncertainty. Additionally, a taxpayer is required to identify and to conduct a process of evaluating the alternatives. The final regulations provide that such a process may involve, for example, modeling, simulation, or a systematic trial and error methodology.

The final regulations further provide that a process of experimentation "must be an evaluative process and generally should be capable of evaluating more than one alternative." (Emphasis added). Although the identification and evaluation of more than a single alternative is not required to satisfy the process of experimentation requirement, the Treasury Department and the IRS believe that a taxpayer's activities, in order to qualify for the research credit, generally should be capable of evaluating more than one alternative and, in any event, must be designed to evaluate the alternative, or alternatives, being considered.

The final regulations state that the mere existence of uncertainty regarding the development or improvement of a business component does not indicate that all of a taxpayer's activities undertaken to achieve that new or improved business component constitute a process of experimentation, even if the taxpayer, in fact, does achieve the new or improved business component. The Treasury Department and the IRS believe that

the inclusion of a separate process of experimentation requirement in the statute makes this proposition clear. However, the Treasury Department and the IRS have included this clarification in the final regulations out of concern that taxpayers have not been giving sufficient weight to the requirement that a taxpayer engage in a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. In particular, this clarification is intended to indicate that merely demonstrating that uncertainty has been eliminated (e.g., the achievement of the appropriate design of a business component when such design was uncertain as of the beginning of a taxpayer's activities) is insufficient to satisfy the process of experimentation requirement. A taxpayer bears the burden of demonstrating that its research activities additionally satisfy the process of experimentation requirement.

As noted above, all of the facts and circumstances of a taxpayer's research activities are taken into account to determine whether the taxpayer identified uncertainty concerning the development or improvement of a business

component, identified one or more alternatives intended to eliminate that uncertainty, and identified and conducted a process of evaluating the alternatives. Although the final regulations set out the core elements of a process of experimentation, how a taxpayer's qualified research activities will reflect these core elements will depend on the facts and circumstances. These core elements will not necessarily occur in a strict, sequential order. A process of experimentation is an evaluative process, and as such, often involves refining throughout much of the process the taxpayer's understanding of the uncertainty the taxpayer is trying to address, modifying the alternatives being evaluated to eliminate that uncertainty, or modifying the process used to evaluate those alternatives.

Accordingly, the final regulations do not provide detailed guidance as to how the regulatory provisions are to be applied to a given factual situation. Rather, the Treasury Department and the IRS have concluded that the application of these provisions will depend on the specific activities being claimed by a taxpayer as qualified research, the nature of the taxpayer's business and industry, and the uncertainties being addressed by the taxpayer's research activities. The Treasury Department and the IRS believe that additional, industry-

specific guidance may be appropriate and request comments on the form of such guidance.

The final regulations do not include the rule contained in the 2001 proposed regulations that a taxpayer’s activities do not constitute a process of experimentation where the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are readily discernible and applicable as of the beginning of the taxpayer's research activities. A number of commentators expressed concern that this rule was too vague and susceptible to conflicting interpretations. In light of the clarifications made in these final regulations, the Treasury Department and the IRS have concluded that this rule is no longer necessary because such activities do not constitute a process of experimentation under the final regulations.

As noted above, the 2001 proposed regulations do not contain a specific recordkeeping requirement beyond the requirements set out in section 6001 and the regulations thereunder. No change regarding recordkeeping is being made in these final regulations. The clarifications being made to the process of experimentation requirement do not impose any recordkeeping requirement on taxpayers beyond the requirements

set out in section 6001 and the regulations thereunder.

Process of experimentation -- substantially all requirement

The 2001 proposed regulations retained the rule in TD 8930 that the "substantially all" requirement of section 41(d)(1)(C) is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistently applied reasonable basis (and without regard to §1.41-2(d)(2)), constitute elements of a process of experimentation for a purpose described in section 41(d)(3). This requirement is applied separately to each business component.

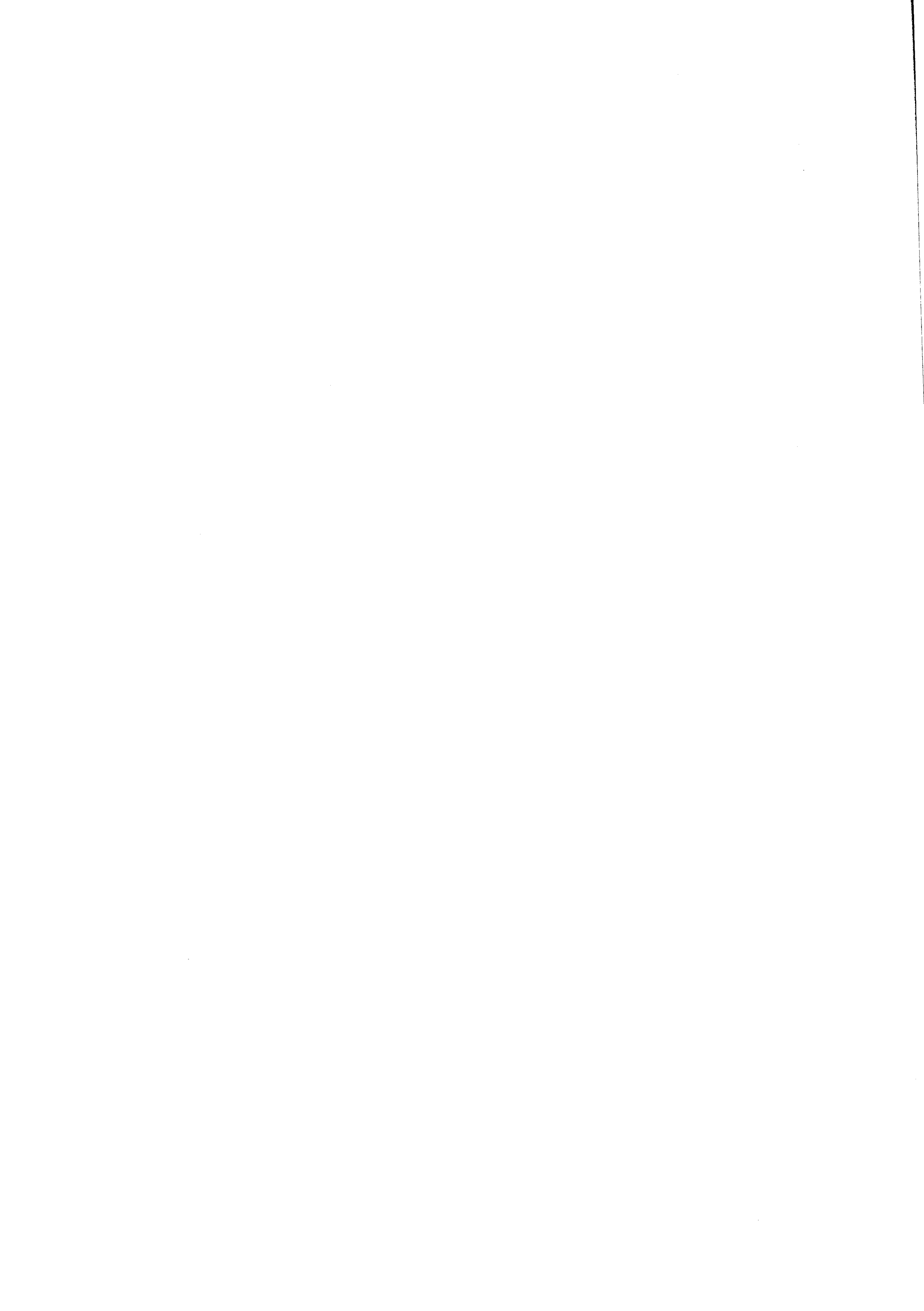
The Treasury Department and the IRS requested comments on the application of the substantially all rule and, in particular, whether research expenses incurred for non-qualified purposes (i.e., relating to style, taste, cosmetic, or seasonal design factors) are includible in the credit computation provided that substantially all of the research activities constitute elements of a process of experimentation for a qualified purpose. After consideration of the comments received, the Treasury Department and the IRS have concluded that the substantially all requirement can be satisfied even if some portion of a taxpayer's activities are not for a qualified purpose.

Accordingly, these final regulations clarify the substantially all rule and provide that the substantially all requirement is satisfied if 20 percent or less of a taxpayer's research activities do not constitute elements of a process of experimentation for a purpose described in section 41(d)(3), so long as these remaining activities satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4). Example (6) of §1.41-4(a)(8) of the 2001 proposed regulations has been modified to illustrate the application of this rule, and appears as example (4) in these final regulations.

Other Issues

Patent safe harbor

Section 1.41-4(a)(3)(iii) of the 2001 proposed regulations generally provided that the issuance of certain patents is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. Some commentators requested that this patent safe harbor be expanded to cover all requirements contained in sections 41(d)(1) and (3). After consideration of these comments, and in light of the



clarifications being made in these final regulations to the provisions relating to the process of experimentation requirement, the Treasury Department and the IRS continue to believe that the patent safe harbor is appropriately limited and, therefore, have not changed the patent safe harbor provision.

Shrinking-back rule

Some commentators expressed concern that the language of the shrinking-back rule in §1.41-4(b)(2) of the 2001 proposed regulations implied that not all of a taxpayer's qualified research expenses would be eligible for the research credit as a result of the application of the rule. This provision has been revised in these final regulations to clarify that the rule is not intended to exclude qualified research expenses from the credit, but rather is intended to ensure that expenses attributable to qualified research activities are eligible for the research credit for purposes of section 41(d)(1).

Research after commercial production

Some commentators requested additional clarification regarding the scope of the research after commercial production, adaptation, and duplication exclusions set out in section 41(d)(4)(A), (B) and (C), and §1.41-4(c)(2), (3) and

(4) of the 2001 proposed regulations. After consideration of these comments, the Treasury Department and the IRS believe that the multitude of factual situations to which these exclusions might apply make it impractical to provide additional clarification that is both meaningful and of broad application. The Treasury Department and the IRS believe these three specific exclusions do not cover research activities that otherwise satisfy the requirements for qualified research. Taxpayers, however, should carefully review (including, as appropriate, the application of the shrinking-back rule) research activities that might otherwise fall within these exclusions to ensure that only eligible activities are being included in their credit computations.

One commentator expressed concern that the language of §1.41-4(c)(2)(iv), relating to the clinical testing of pharmaceutical products, could exclude from credit eligibility clinical trials performed under an arrangement where the Food and Drug Administration has granted conditional approval for a pharmaceutical product contingent upon the results of additional clinical trials. Another commentator expressed concern that the language would exclude otherwise qualifying activities because the research was not required to be approved by the Food and Drug Administration. Section 1.41-

4(c)(2)(iv) is not a rule of exclusion. As stated above, the Treasury Department and the IRS believe that the research after commercial production exclusion (as well as the adaptation and duplication exclusions) do not cover research activities, including these additional clinical trials, so long as such trials satisfy the requirements for qualified research.

Gross receipts

These final regulations retain the broad definition of gross receipts contained in TD 8930. In response to Notice 2001-19, a number of commentators reiterated earlier comments that this definition was overly broad. As stated in the preamble to the 2001 proposed regulations, the Treasury Department and the IRS continue to believe that the definition of gross receipts should be construed broadly, and, accordingly, no change has been made in these final regulations to the definition contained in TD 8930.

Examples

The examples in the regulations have been changed to remove references to "readily discernible and applicable." While the Treasury Department and the IRS continue to believe that the activities in Examples 4 and 5 of §1.41-4(a)(8) of

the 2001 proposed regulations would not qualify under the final regulations, these examples were removed as the only purpose of these examples was to illustrate the "readily discernable and applicable" standard. Minor changes to the facts in Example 4 of §1.41-4(a)(8) in the final regulations (Example 6 of §1.41-4(a)(8) of the 2001 proposed regulations) were made to illustrate more clearly the application of the substantially all requirement of §1.41-4(a)(6). These changes do not indicate that the Treasury Department and the IRS believe that the integration activities removed from the example, as contained in the 2001 proposed regulations, are or are not qualified activities standing alone. The determination of whether activities are qualified research is based on the specific facts and circumstances of those activities.

Additionally, minor changes were made to the examples in §1.41-4(c)(10) to remove references to "readily discernable and applicable" and to make some clarifications based on comments received. Example 1 of §1.41-4(c)(10) was modified to remove the conclusion regarding qualification of expenses under section 174. Although the Treasury Department and the IRS continue to believe that the conclusion in the 2001 proposed regulations is correct, the Treasury Department and

the IRS believe that the point illustrated in the removed portion of the example would be more appropriately addressed in guidance issued under section 174, rather than in guidance under section 41.

Effective Date

Notice 2001-19 stated, in relevant part, that the provisions of TD 8930, including any changes to TD 8930, would be effective no earlier than the date when the completion of the Treasury Department and the IRS' review of TD 8930 was announced. The 2001 proposed regulations provided, in relevant part, that final regulations would apply to taxable years ending on or after December 26, 2001, the date the proposed regulations were published in the **Federal Register**.

Because these final regulations only clarify the provisions of the 2001 proposed regulations, these final regulations apply to taxable years ending on or after **[INSERT DATE THIS DOCUMENT IS FILED WITH THE FEDERAL REGISTER]**. For taxable years ending before **[INSERT DATE THIS DOCUMENT IS FILED WITH THE FEDERAL REGISTER]**, the IRS will not challenge return positions that are consistent with these final regulations.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Act Analysis is not required. Pursuant to section 7805(f), 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 Nicole R. Cimino of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

Adoption of Amendments to the Regulations

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

PART I--INCOME TAXES

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

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

Par. 2. Section 1.41-0 is amended as follows:

1. Revising the entries for §1.41-4.

The revisions and additions read as follows:

§1.41-0 Table of contents.

* * * * *

§1.41-4 Qualified research for expenditures paid or incurred in taxable years ending on or after **[INSERT DATE THIS DOCUMENT IS FILED WITH THE FEDERAL REGISTER]**.

(a) Qualified research.
(1) General rule.
(2) Requirements of section 41(d)(1).
(3) Undertaken for the purpose of discovering information.
(i) In general.
(ii) Application of the discovering information requirement.
(iii) Patent safe harbor.
(4) Technological in nature.
(5) Process of experimentation.
(i) In general.
(ii) Qualified purpose.
(6) Substantially all requirement.
(7) Use of computers and information technology.
(8) Illustrations.
(b) Application of requirements for qualified research.
(1) In general.
(2) Shrinking-back rule.
(3) Illustration.
(c) Excluded activities.
(1) In general.
(2) Research after commercial production.
(i) In general.
(ii) Certain additional activities related to the business component.
(iii) Activities related to production process or technique.

(iv) Clinical testing.
(3) Adaptation of existing business components.
(4) Duplication of existing business component.
(5) Surveys, studies, research relating to management functions, etc.
(6) Internal use software for taxable years beginning on or after December 31, 1985. **[Reserved].**
(7) Activities outside the United States, Puerto Rico, and other possessions.
(i) In general.
(ii) Apportionment of in-house research expenses.
(iii) Apportionment of contract research expenses.
(8) Research in the social sciences, etc.
(9) Research funded by any grant, contract, or otherwise.
(10) Illustrations.
(d) Recordkeeping for the research credit.
(e) Effective dates.

* * * * *

Par. 3. Section 1.41-4 is amended as follows:

1. Paragraphs (a)(2)(iii), (a)(3), (a)(4), (a)(5), (a)(6), (a)(8), (b)(2), (b)(3), (c)(2)(iv), and (c)(4) are revised.

2. Paragraph (c)(6) is reserved.

3. Paragraphs (c)(7)(ii), (c)(10), (d), and (e) are revised.

The revisions and additions read as follows:

§1.41-4 Qualified research for expenditures paid or incurred in taxable years ending on or after **[INSERT DATE THIS DOCUMENT IS FILED WITH THE FEDERAL REGISTER]**.

(a)* * *

(2)* * *

(iii) Substantially all of the activities of which constitute elements of a process of experimentation that relates to a qualified purpose.

(3) Undertaken for the purpose of discovering information--(i) In general. For purposes of section 41(d) and this section, research must be undertaken for the purpose of discovering information that is technological in nature. Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

(ii) Application of the discovering information requirement. A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. In addition, a determination that research is

undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer succeed in developing a new or improved business component.

(iii) Patent safe harbor. For purposes of section 41(d) and paragraph (a)(3)(i) of this section, the issuance of a patent by the Patent and Trademark Office under the provisions of 35 U.S.C. 151 (other than a patent for design issued under the provisions of 35 U.S.C. 171) is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. However, the issuance of such a patent is not a precondition for credit availability.

(4) Technological in nature. For purposes of section 41(d) and this section, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

(5) Process of experimentation--(i) In general. For purposes of section 41(d) and this section, a process of

experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involves the identification of uncertainty concerning the development or improvement of a business component, the identification of one or more alternatives intended to eliminate that uncertainty, and the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology). A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative. A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayer’s capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer’s research activities. Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities

undertaken to achieve that new or improved business component constitute a process of experimentation.

(ii) Qualified purpose. For purposes of section 41(d) and this section, a process of experimentation is undertaken for a qualified purpose if it relates to a new or improved function, performance, reliability or quality of the business component. Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors.

(6) Substantially all requirement. In order for activities to constitute qualified research under section 41(d)(1), substantially all of the activities must constitute elements of a process of experimentation that relates to a qualified purpose. The substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied only if 80 percent or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis (and without regard to §1.41-2(d)(2)), constitute elements of a process of experimentation for a purpose described in section 41(d)(3). Accordingly, if 80 percent (or more) of a taxpayer's research activities with respect to a business component constitute elements of a process of experimentation for a purpose

described in section 41(d)(3), the substantially all requirement is satisfied even if the remaining 20 percent (or less) of a taxpayer's research activities with respect to the business component do not constitute elements of a process of experimentation for a purpose described in section 41(d)(3), so long as these remaining research activities satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4). The substantially all requirement is applied separately to each business component.

* * * * *

(8) Illustrations. The following examples illustrate the application of paragraph (a)(5) of this section:

Example 1. (i) Facts. X is engaged in the business of developing and manufacturing widgets. X wants to change the color of its blue widget to green. X obtains from various suppliers several different shades of green paint. X paints several sample widgets, and surveys X's customers to determine which shade of green X's customers prefer.

(ii) Conclusion. X's activities to change the color of its blue widget to green are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section because substantially all of X's activities are not undertaken for a qualified purpose. All of X's research activities are related to style, taste, cosmetic, or seasonal design factors.

Example 2. (i) Facts. The facts are the same as in Example 1, except that X chooses one of the green paints. X obtains samples of the green paint from a supplier and determines that X must modify its painting process to accommodate the green paint because the green paint has different characteristics from other paints X has used. X obtains detailed data on the green paint from X's paint

supplier. X also consults with the manufacturer of X's paint spraying machines. The manufacturer informs X that X must acquire a new nozzle that operates with the green paint X wants to use. X tests the nozzles to ensure that they work as specified by the manufacturer of the paint spraying machines.

(ii) Conclusion. X's activities to modify its painting process are a separate business component under section 41(d)(2)(A). X's activities to modify its painting process to change the color of its blue widget to green are not qualified research under section 41(d)(1) and paragraph (a)(5) of this section. X did not conduct a process of evaluating alternatives in order to eliminate uncertainty regarding the modification of its painting process. Rather, the manufacturer of the paint machines eliminated X's uncertainty regarding the modification of its painting process. X's activities to test the nozzles to determine if the nozzles work as specified by the manufacturer of the paint spraying machines are in the nature of routine or ordinary testing or inspection for quality control.

Example 3. (i) Facts. X is engaged in the business of manufacturing food products and currently manufactures a large-shred version of a product. X seeks to modify its current production line to permit it to manufacture both a large-shred version and a fine-shred version of one of its food products. A smaller, thinner shredding blade capable of producing a fine-shred version of the food product, however, is not commercially available. Thus, X must develop a new shredding blade that can be fitted onto its current production line. X is uncertain concerning the design of the new shredding blade, because the material used in its existing blade breaks when machined into smaller, thinner blades. X engages in a systematic trial and error process of analyzing various blade designs and materials to determine whether the new shredding blade must be constructed of a different material from that of its existing shredding blade and, if so, what material will best meet X's functional requirements.

(ii) Conclusion. X's activities to modify its current production line by developing the new shredding blade meet the requirements of qualified research as set forth in paragraph (a)(2) of this section. Substantially all of X's activities constitute elements of a process of experimentation because X evaluated alternatives to achieve a result where the method of

achieving that result, and the appropriate design of that result, were uncertain as of the beginning of the taxpayer's research activities. X identified uncertainties related to the development of a business component, and identified alternatives intended to eliminate these uncertainties. Furthermore, X's process of evaluating identified alternatives was technological in nature, and was undertaken to eliminate the uncertainties.

Example 4. (i) Facts. X is in the business of designing, developing and manufacturing automobiles. In response to government-mandated fuel economy requirements, X seeks to update its current model vehicle and undertakes to improve aerodynamics by lowering the hood of its current model vehicle. X determines, however, that lowering the hood changes the air flow under the hood, which changes the rate at which air enters the engine through the air intake system, and which reduces the functionality of the cooling system. X's engineers are uncertain how to design a lower hood to obtain the increased fuel economy, while maintaining the necessary air flow under the hood. X designs, models, simulates, tests, refines, and re-tests several alternative designs for the hood and associated proposed modifications to both the air intake system and cooling system. This process enables X to eliminate the uncertainties related to the integrated design of the hood, air intake system, and cooling system, and such activities constitute eighty-five percent of X's total activities to update its current model vehicle. X then engages in additional activities that do not involve a process of evaluating alternatives in order to eliminate uncertainties. The additional activities constitute only fifteen percent of X's total activities to update its current model vehicle.

(ii) Conclusion. In general, if eighty percent or more of a taxpayer's research activities measured on a cost or other consistently applied reasonable basis constitute elements of a process of experimentation for a qualified purpose under section 41(d)(3)(A) and paragraph (a)(5)(ii) of this section, then the substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied. Substantially all of X's activities constitute elements of a process of experimentation because X evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were

uncertain as of the beginning of X's research activities. X identified uncertainties related to the improvement of a business component and identified alternatives intended to eliminate these uncertainties. Furthermore, X's process of evaluating the identified alternatives was technological in nature and was undertaken to eliminate the uncertainties. Because substantially all (in this example, eighty-five percent) of X's activities to update its current model vehicle constitute elements of a process of experimentation for a qualified purpose described in section 41(d)(3)(A), all of X's activities to update its current model vehicle meet the requirements of qualified research as set forth in paragraph (a)(2) of this section, provided that X's remaining activities (in this example, fifteen percent of X's total activities) satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4).

(b)* * *

(2) Shrinking-back rule. The requirements of section 41(d) and paragraph (a) of this section are to be applied first at the level of the discrete business component, that is, the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. If these requirements are not met at that level, then they apply at the most significant subset of elements of the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license. This shrinking back of the product is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the

product is reached and such element fails to satisfy the test. This shrinking-back rule is applied only if a taxpayer does not satisfy the requirements of section 41(d)(1) and paragraph (a)(2) of this section with respect to the overall business component. The shrinking-back rule is not itself applied as a reason to exclude research activities from credit eligibility.

(3) Illustration. The following example illustrates the application of this paragraph (b):

Example. X, a motorcycle engine builder, develops a new carburetor for use in a motorcycle engine. X also modifies an existing engine design for use with the new carburetor. Under the shrinking-back rule, the requirements of section 41(d)(1) and paragraph (a) of this section are applied first to the engine. If the modifications to the engine when viewed as a whole, including the development of the new carburetor, do not satisfy the requirements of section 41(d)(1) and paragraph (a) of this section, those requirements are applied to the next most significant subset of elements of the business component. Assuming that the next most significant subset of elements of the engine is the carburetor, the research activities in developing the new carburetor may constitute qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section.

(c)* * *

(2)* * *

(iv) Clinical testing. Clinical testing of a pharmaceutical product prior to its commercial production in the United States is not treated as occurring after the beginning of commercial production even if the product is commercially available in other countries. Additional

clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the Food and Drug Administration and is ready for commercial production and sale is not treated as occurring after the beginning of commercial production if such clinical testing is undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product. A functional use, characteristic, indication, combination, dosage, or delivery form shall be considered new only if such functional use, characteristic, indication, combination, dosage, or delivery form must be approved by the Food and Drug Administration.

* * * * *

(4) Duplication of existing business component. Activities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component are not qualified research. This exclusion does not apply merely because the taxpayer examines an existing business component in the course of developing its own business component.

* * * * *

(6) Internal use software for taxable years beginning on or after December 31, 1985. **[Reserved].**

(7)* * *

(ii) Apportionment of in-house research expenses. In-house research expenses paid or incurred for qualified services performed both in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States must be apportioned between the services performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and the services performed outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States. Only those in-house research expenses apportioned to the services performed within the United States, the Commonwealth of Puerto Rico and other possessions of the United States are eligible to be treated as qualified research expenses, unless the in-house research expenses are wages and the 80 percent rule of §1.41-2(d)(2) applies.

* * * * *

(10) Illustrations. The following examples illustrate provisions contained in paragraphs (c)(1) through (9) (excepting (c)(6)) of this section. No inference should be

drawn from these examples concerning the application of section 41(d)(1) and paragraph (a) of this section to these facts. The examples are as follows:

Example 1. (i) Facts. X, a tire manufacturer, develops a new material to use in its tires. X conducts research to determine the changes that will be necessary for X to modify its existing manufacturing processes to manufacture the new tire. X determines that the new tire material retains heat for a longer period of time than the materials X currently uses for tires, and, as a result, the new tire material adheres to the manufacturing equipment during tread cooling. X evaluates several alternatives for processing the treads at cooler temperatures to address this problem, including a new type of belt for its manufacturing equipment to be used in tread cooling. Such a belt is not commercially available. Because X is uncertain of the belt design, X develops and conducts sophisticated engineering tests on several alternative designs for a new type of belt to be used in tread cooling until X successfully achieves a design that meets X's requirements. X then manufactures a set of belts for its production equipment, installs the belts, and tests the belts to make sure they were manufactured correctly.

(ii) Conclusion. X's research with respect to the design of the new belts to be used in its manufacturing of the new tire may be qualified research under section 41(d)(1) and paragraph (a) of this section. However, X's expenses to implement the new belts, including the costs to manufacture, install, and test the belts were incurred after the belts met the taxpayer's functional and economic requirements and are excluded as research after commercial production under section 41(d)(4)(A) and paragraph (c)(2) of this section.

Example 2. (i) Facts. For several years, X has manufactured and sold a particular kind of widget. X initiates a new research project to develop a new or improved widget.

(ii) Conclusion. X's activities to develop a new or improved widget are not excluded from the definition of qualified research under section 41(d)(4)(A) and paragraph (c)(2) of this section. X's activities relating to the

development of a new or improved widget constitute a new research project to develop a new business component. X's research activities relating to the development of the new or improved widget, a new business component, are not considered to be activities conducted after the beginning of commercial production under section 41(d)(4)(A) and paragraph (c)(2) of this section.

Example 3. (i) Facts. X, a computer software development firm, owns all substantial rights in a general ledger accounting software core program that X markets and licenses to customers. X incurs expenditures in adapting the core software program to the requirements of C, one of X's customers.

(ii) Conclusion. Because X's activities represent activities to adapt an existing software program to a particular customer's requirement or need, X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section.

Example 4. (i) Facts. The facts are the same as in Example 3, except that C pays X to adapt the core software program to C's requirements.

(ii) Conclusion. Because X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, C's payments to X are not for qualified research and are not considered to be contract research expenses under section 41(b)(3)(A).

Example 5. (i) Facts. The facts are the same as in Example 3, except that C's own employees adapt the core software program to C's requirements.

(ii) Conclusion. Because C's employees' activities to adapt the core software program to C's requirements are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, the wages C paid to its employees do not constitute in-house research expenses under section 41(b)(2)(A).

Example 6. (i) Facts. X manufacturers and sells rail cars. Because rail cars have numerous specifications related to performance, reliability and quality, rail car designs are

subject to extensive, complex testing in the scientific or laboratory sense. B orders passenger rail cars from X. B's rail car requirements differ from those of X's other existing customers only in that B wants fewer seats in its passenger cars and a higher quality seating material and carpet that are commercially available. X manufactures rail cars meeting B's requirements.

(ii) Conclusion. X's activities to manufacture rail cars for B are excluded from the definition of qualified research. The rail car sold to B was not a new business component, but merely an adaptation of an existing business component that did not require a process of experimentation. Thus, X's activities to manufacture rail cars for B are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section because X's activities represent activities to adapt an existing business component to a particular customer's requirement or need.

Example 7. (i) Facts. X, a manufacturer, undertakes to create a manufacturing process for a new valve design. X determines that it requires a specialized type of robotic equipment to use in the manufacturing process for its new valves. Such robotic equipment is not commercially available, and X, therefore, purchases the existing robotic equipment for the purpose of modifying it to meet its needs. X's engineers identify uncertainty that is technological in nature concerning how to modify the existing robotic equipment to meet its needs. X's engineers develop several alternative designs, and conduct experiments using modeling and simulation in modifying the robotic equipment and conduct extensive scientific and laboratory testing of design alternatives. As a result of this process, X's engineers develop a design for the robotic equipment that meets X's needs. X constructs and installs the modified robotic equipment on its manufacturing process.

(ii) Conclusion. X's research activities to determine how to modify X's robotic equipment for its manufacturing process are not excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, provided that X's research activities satisfy the requirements of section 41(d)(1).

Example 8. (i) Facts. An existing gasoline additive is manufactured by Y using three ingredients, A, B, and C. X seeks to develop and manufacture its own gasoline additive that appears and functions in a manner similar to Y's additive. To develop its own additive, X first inspects the composition of Y's additive, and uses knowledge gained from the inspection to reproduce A and B in the laboratory. Any differences between ingredients A and B that are used in Y's additive and those reproduced by X are insignificant and are not material to the viability, effectiveness, or cost of A and B. X desires to use with A and B an ingredient that has a materially lower cost than ingredient C. Accordingly, X engages in a process of experimentation to develop, analyze and test potential alternative formulations of the additive.

(ii) Conclusion. X's activities in analyzing and reproducing ingredients A and B involve duplication of existing business components and are excluded from the definition of qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section. X's experimentation activities to develop potential alternative formulations of the additive do not involve duplication of an existing business component and are not excluded from the definition of qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section.

Example 9. (i) Facts. X, a manufacturing corporation, undertakes to restructure its manufacturing organization. X organizes a team to design an organizational structure that will improve X's business operations. The team includes X's employees as well as outside management consultants. The team studies current operations, interviews X's employees, and studies the structure of other manufacturing facilities to determine appropriate modifications to X's current business operations. The team develops a recommendation of proposed modifications which it presents to X's management. X's management approves the team's recommendation and begins to implement the proposed modifications.

(ii) Conclusion. X's activities in developing and implementing the new management structure are excluded from the definition of qualified research under section 41(d)(4)(D) and paragraph (c)(5) of this section. Qualified research does not include activities relating to management functions or

techniques including management organization plans and management-based changes in production processes.

Example 10. (i) Facts. X, an insurance company, develops a new life insurance product. In the course of developing the product, X engages in research with respect to the effect of pricing and tax consequences on demand for the product, the expected volatility of interest rates, and the expected mortality rates (based on published data and prior insurance claims).

(ii) Conclusion. X's activities related to the new product represent research in the social sciences (including economics and business management) and are thus excluded from the definition of qualified research under section 41(d)(4)(G) and paragraph (c)(8) of this section.

(d) Recordkeeping for the research credit. A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see §1.6001-1. To facilitate compliance and administration, the IRS and taxpayers may agree to guidelines for the keeping of specific records for purposes of substantiating research credits.

(e) Effective dates. This section is applicable for taxable years ending on or after **[INSERT DATE THIS DOCUMENT IS FILED WITH THE FEDERAL REGISTER]**.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

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

Par. 5. In §602.101, paragraph (b) is amended by removing the entry to the table for §1.41-4(d).

Deputy Commissioner for Services and Enforcement.

Assistant Secretary of the Treasury.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-153656-03]

RIN 1545-BC70

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: This document invites comments from the public regarding certain rules and standards relating to internal-use software under section 41(d)(4)(E) of the Internal Revenue Code. All materials submitted will be available for public inspection and copying. This document also addresses the effective date for final rules relating to internal-use software.

DATES: Comments are requested on or before **[INSERT DATE]**.

ADDRESSES: Send written comments to: Internal Revenue Service, Attn: CC:PA:LPD:PR [REG-153656-03], room 5203, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, taxpayers may submit comments in writing, by hand delivery to CC:PA:LPD:PR [REG-153656-03], Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW., Washington, DC, or electronically, via the IRS Internet site

at: www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Nicole R. Cimino at (202) 622-3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Introduction

On **[INSERT DATE FINAL REGULATIONS ARE FILED WITH THE FEDERAL REGISTER]**, the Treasury Department and the IRS issued final regulations (TD **XXXX**) for the credit for increasing research activities under section 41 (research credit). TD **XXXX** provides rules relating to the definition of qualified research under section 41(d) but does not finalize rules relating to internal-use software under section 41(d)(4)(E). This advance notice of proposed rulemaking (ANPRM) invites comments from the public regarding the proposed regulations issued in 2001 relating to internal-use software under section 41(d)(4)(E). Although the Treasury Department and the IRS welcome comments on all aspects of those proposed regulations, the Treasury Department and the IRS specifically request comments concerning the definition of internal-use software. In addition, the Treasury Department and the IRS request comments on whether final rules relating to internal-use software should have retroactive effect.

Background

Section 41(d)(4)(E) provides that, except to the extent provided by regulations, research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer (internal-use software) is excluded from the definition of qualified research under section 41(d). (Software that is developed for use in an activity which constitutes qualified research and software that is developed for use in a production process with respect to which the general credit eligibility requirements are satisfied are not excluded as internal-use software under the provisions of section 41(d)(4)(E).) The statutory exclusion for internal-use software and the regulatory exceptions to this exclusion have been the subject of a series of proposed and final regulations.

Legislative History

The legislative history to the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085)(1986 Act), states that "the costs of developing software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services) except to the extent permitted by Treasury regulations." See H.R.

Conf. Rep. No. 841, at II-73 (1986 legislative history). The 1986 legislative history further states that Congress intended that regulations would make the costs of new or improved internal-use software eligible for the credit only if the research satisfies, in addition to the general requirements for credit eligibility, an additional, three-part high threshold of innovation test (i.e., that the software was innovative, that the software development involved significant economic risk, and that the software was not commercially available for use by the taxpayer).

Congress has extended the research credit a number of times since the 1986 Act but has not made any changes to the statutory definition of qualified research or to the statutory exclusion for internal-use software in section 41(d)(4)(E). When Congress extended the research credit in the Tax Relief Extension Act of 1999, Public Law 106-170 (113 Stat. 1860) (1999 Act), however, the legislative history stated the following with respect to internal-use software:

> The conferees further note the rapid pace of technological advance, especially in service-related industries, and urge the Secretary to consider carefully the comments he has and may receive in promulgating regulations in connection with what constitutes "internal use" with regard to software expenditures. The conferees also wish to observe that software research, that otherwise satisfies the requirements of section 41, which is undertaken to support the provision of a service, should not be

> deemed "internal use" solely because the business component involves the provision of a service.

H.R. Conf. Rep. No. 106-478, at 132 (1999).

1997 Proposed Regulations

On January 2, 1997, the Treasury Department and the IRS published proposed regulations (REG-209494-90, 1997-1 C.B. 723) in the **Federal Register** (62 FR 81) under section 41 relating to internal-use software (1997 proposed regulations). In relevant part, the 1997 proposed regulations stated:

> Research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if the software satisfies the requirements of paragraph (e)(2) of this section. Generally, research with respect to computer software is not eligible for the research credit where software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services).

Prop. §1.41-4(e)(1) (1997).

The 1997 proposed regulations contained an exception to the internal-use software rules for certain software developed by the taxpayer as a part of a new or improved package of computer software and hardware developed together as a single product. Such software would not be subject to the high threshold of innovation requirements for internal-use software

under the 1997 proposed regulations. The 1997 proposed regulations, however, did not contain a specific definition of internal-use software. Instead, the 1997 proposed regulations provided that the determination of whether software was internal-use software would depend on the facts and circumstances of each case:

> All relevant facts and circumstances are to be considered in determining if computer software is developed primarily for the taxpayer's internal use. If computer software is developed primarily for the taxpayer's internal use, the requirements of this paragraph (e) apply even though the taxpayer intends to, or subsequently does, sell, lease, or license the computer software.

Prop. §1.41-4(e)(4) (1997).

2001 Final Regulations (TD 8930)

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 280) final regulations (TD 8930) relating, in relevant part, to the definition of internal-use software for purposes of section 41(d)(4)(E). With respect to the general definition of internal-use software, TD 8930 provided:

> Software is developed primarily for the taxpayer's internal use if the software is to be used internally, for example, in general administrative functions of the taxpayer (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services). If computer software is developed primarily for the taxpayer's internal use, the requirements of this paragraph

(c)(6) apply even though the taxpayer intends to, or subsequently does, sell, lease, or license the computer software.

§1.41-4(c)(6)(iv). TD 8930, therefore, did not provide a specific definition of internal-use software but instead identified two general categories of software as examples of internal-use software: software "used internally" and software used "in providing noncomputer services." TD 8930 eliminated the general facts and circumstances standard contained in the 1997 proposed regulations.

The preamble to TD 8930 addressed the requests made by some commentators that the definition of internal-use software exclude software used to deliver a service to customers and software that includes an interface with customers or the public. The preamble stated that after careful analysis of the legislative history, the Treasury Department and the IRS had concluded that such broad exclusions would be inconsistent with the statutory mandate, because the exclusion would extend to some software that Congress clearly intended to treat as internal-use software. The preamble, however, continued by highlighting changes that had been made in TD 8930 to take into account the commentators' concerns as well as the legislative history to the 1999 Act.

First, TD 8930 provided that the high threshold of

innovation test applicable to internal-use software does not apply to software used to provide computer services (defined in TD 8930 generally as a service offered by a taxpayer to customers who conduct business with the taxpayer primarily for the use of the taxpayer's computer or software technology). In contrast, software used to provide a noncomputer service (defined in TD 8930 generally as a service other than a computer service, even if such other service is enabled, supported, or facilitated by computer or software technology) would be subject to the high threshold of innovation test under TD 8930.

Second, TD 8930 contained a new exception to the high threshold of innovation test for internal-use software for software used to provide a noncomputer service if the software, among other things, contained features or improvements not yet offered by a taxpayer's competitors. In describing this exception, the preamble to TD 8930 stated:

> This exercise of regulatory authority [to create the exception for certain software used to provide non-computer services] is based on a determination that the development of software containing features or improvements that are not available from a taxpayer's competitors and that provide a demonstrable competitive advantage is more likely to increase the innovative qualities and efficiency of the U.S. economy (by generating knowledge that can be used by other service providers) than is the development of software used to provide noncomputer services containing features or improvements that

> are already offered by others. IRS and Treasury believe that drawing such a line is an appropriate way to administer the credit with a view to identifying and facilitating the credit availability for software with the greatest potential for benefiting the U.S. economy, an important rationale for the research credit.

In response to taxpayer concerns, on January 31, 2001, the Treasury Department and the IRS published Notice 2001-19 (2001-10 I.R.B. 784), announcing that the Treasury Department and the IRS would review TD 8930 and reconsider comments previously submitted in connection with the finalization of TD 8930.

2001 Proposed Regulations

On December 26, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 66362) a notice of proposed rulemaking (REG-112991-01) reflecting their review of TD 8930 (2001 proposed regulations). The 2001 proposed regulations revised the definition of internal-use software as compared to the definitions contained in the 1997 proposed regulations and TD 8930. The definition in the 2001 proposed regulations was based on a presumption that turns on whether the software is developed to be commercially sold, leased, licensed, or otherwise marketed for separately stated consideration:

> Unless computer software is developed to be commercially sold, leased, licensed, or otherwise

> marketed, for separately stated consideration to unrelated third parties, computer software is presumed developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use. For example, the computer software may serve general and administrative functions of the taxpayer, or may be used in providing a noncomputer service. General and administrative functions include, but are not limited to, functions such as payroll, bookkeeping, financial management, financial reporting, personnel management, sales and marketing, fixed asset accounting, inventory management and cost accounting. Computer software that is developed to be commercially sold, leased, licensed or otherwise marketed, for separately stated consideration to unrelated third parties is not developed primarily for the taxpayer's internal use. The requirements of this paragraph (c)(6) apply to computer software that is developed primarily for the taxpayer's internal use even though the taxpayer subsequently sells, leases, licenses, or otherwise markets the computer software for separately stated consideration to unrelated third parties.

Prop. §1.41-4(c)(6)(iv) (2001) (emphasis added).

As explained in the preamble to the 2001 proposed regulations, this "separately stated consideration" standard reflected the Treasury Department and the IRS' determination that software that is sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties is software that is intended to be used primarily by the customers of the taxpayer, whereas software that does not satisfy this requirement is software that is intended to be used primarily by the taxpayer for its internal use or in connection with a noncomputer service provided by

the taxpayer. The 2001 proposed regulations modified the hardware-software exception and continued to provide that software used to provide computer services was not required to satisfy the additional qualification requirements imposed on internal-use software. The new proposed regulations, however, eliminated the special rule in TD 8930 for certain software used to provide noncomputer services. The preamble to the 2001 proposed regulations explained that "[d]ue to other revisions contained in these proposed regulations, Treasury and the IRS believe that the computer software targeted by this rule generally would be credit eligible without this rule."

The preamble to the 2001 proposed regulations also addressed the continued concerns expressed by some commentators that the definition of internal-use software should not include software used to deliver a service to customers and software that includes an interface with customers or the public. In addition to repeating the Treasury Department and IRS' concern that such exclusions may conflict with Congress' intent regarding software used in the provision of noncomputer services, the preamble stated that an exclusion for software that includes an interface with customers or the public would entail substantial

administrative difficulties and "may inappropriately permit certain categories of costs (e.g., certain web site development costs) to constitute qualified research expenses without having to satisfy the high threshold of innovation test."

Discussion

Prior regulatory guidance generally reflects three approaches to the definition of internal-use software. First, the 1997 proposed regulations closely mirrored the language contained in the legislative history but did not provide a specific definition of internal-use. Instead, the 1997 proposed regulations used the "general and administrative functions" and "noncomputer services" language from the legislative history as examples of internal-use software and provided that the determination of whether particular software was internal-use software required an evaluation of "all relevant facts and circumstances."

TD 8930 then attempted to provide greater specificity regarding the definition of internal-use software. Although TD 8930 eliminated the facts and circumstances test in the 1997 proposed regulations, TD 8930 continued to provide a general definition of internal-use software that incorporated the legislative history's examples of general and

administrative functions and non-computer services. Additionally, TD 8930 provided that software used by the taxpayer to provide "computer services" was not subject to the high threshold of innovation test applicable to internal-use software, and provided definitions of computer services and noncomputer services. The exception for computer services software, however, required a determination of the primary reason why a taxpayer's customers conduct business with the taxpayer. TD 8930 also applied this exception to certain software used to provide "noncomputer services" provided that the software satisfied additional requirements intended to identify software containing new features or improvements that provide a competitive advantage to the taxpayer.

Finally, the 2001 proposed regulations prescribed a bright-line, separately-stated consideration rule for determining which software is treated as internal-use software for purposes of the research credit. (The 2001 proposed regulations retained the exception for software used to provide computer services, but removed the special rule for noncomputer services. Additionally, the 2001 proposed regulations expanded upon the list of general and administrative functions contained in the legislative history and expanded the exception for integrated software-hardware

products.) The purpose of this rule was to provide a clear definition of internal-use software that could be readily applied by taxpayers and more readily administered by the IRS.

Numerous comments were received in response to the 1997 proposed regulations, TD 8930 and Notice 2001-19, and the 2001 proposed regulations regarding the provisions relating to internal-use software. Although commentators addressed virtually all aspects of the internal-use software provisions in the various iterations of regulations, most of the comments focused on the definition of internal-use software. As previously stated, many commentators believed that the definition of internal-use software should exclude any software used to deliver a service to customers and any software that includes an interface with customers or the public. Some commentators suggested, as an alternative, that the statutory production process exception be extended to software used in connection with the provision of services.

With respect to the definition of internal-use software in the 2001 proposed regulations, commentators stated that the separately-stated consideration test was a poor indication of when computer software was developed "primarily for internal use by the taxpayer" and directly conflicted with the legislative history to the 1999 Act. In support of a narrower

definition of internal-use software, these commentators pointed to technological advancements and changes to the role of computer software in business activities since the exclusion for internal-use software was enacted in 1986, including the increased development of computer software by taxpayers, the increased use of computer software in all aspects of business activity, and the role of computer software (often integrated across a business) in providing goods and services in addition to the internal operations of a business. Commentators further argued that the definition should be based on the underlying functionality of the software (i.e., whether the software, in light of the facts and circumstances, is used to deliver services or goods to a taxpayer's customers). Commentators urged that a functionality rule is preferable to a bright-line rule (such as the separately-stated consideration rule in TD 8930) even though a bright-line rule provided a clearer rule for identifying internal-use software for purposes of the research credit.

The Treasury Department and the IRS are continuing to consider the concerns raised by commentators in response to the definition of internal-use software contained in the 2001 proposed regulations, including the concern that the

separately-stated consideration test is over-inclusive. Nevertheless, the Treasury Department and the IRS are concerned that the alternatives, including expanded or modified exceptions, proposed by commentators generally would make the definition of internal-use software more complex without providing additional clarity. Several commentators suggested similar definitions that would exclude software that, for example, is "integral and essential" to the provision of services with integral defined as software that directly "enables, supports, or facilitates" a service. Some commentators suggested a definition that would exclude software that is "primarily used" by customers, suppliers, or other third parties. Other commentators suggested a definition that would limit internal-use software to software that is developed primarily for use in general and administrative functions that enable, facilitate, or support the taxpayer's conduct of the taxpayer's trade or business, but would exclude certain customer interface software. These suggestions would introduce many terms (including enable, support, facilitate, primarily) that, due to their subjective nature, the Treasury Department and the IRS believe would be prone to controversy and could not be readily applied by taxpayers or administered by the IRS. Another commentator

suggested limiting the definition of internal-use software to software used to perform a specifically enumerated list of general and administrative functions. Some commentators, however, have noted that the often highly integrated nature of software development today makes it difficult, if not impossible, to divide software development projects into separate components, and thus a list approach may not be administrable. Finally, as part of their review of these comments, the Treasury Department and the IRS also reviewed the possibility of using definitions of internal-use software contained in prior guidance.

In light of the statute, the legislative history, the history of the regulations regarding internal-use software, and the comments received, the Treasury Department and the IRS have decided not to finalize in TD **XXXX** the provisions in the 2001 proposed regulations relating to internal-use software. Instead, the Treasury Department and the IRS are issuing this ANPRM to solicit further comments regarding the definition of internal-use software as well as other provisions affecting the qualification of internal-use software for the research credit. The Treasury Department and the IRS are mindful that Congress specifically intended that computer software "developed by (or for the benefit of) the taxpayer primarily

for internal use by the taxpayer" be subject to additional requirements before the software could qualify for the research credit. At the same time, the Treasury Department and the IRS recognize that there have been changes in computer software, and its role in business activity, since the mid-1980s. In light of these changes, the Treasury Department and the IRS are concerned about the difficulty of effecting Congressional intent behind the exclusion for internal-use software with respect to computer software being developed today. Despite Congress' broad grant of regulatory authority in section 41(d)(4)(E), the Treasury Department and the IRS believe that this authority may not be broad enough to resolve those difficulties.

Accordingly, the Treasury Department and the IRS request comments regarding a definition of internal-use software that appropriately reflects the statute and legislative history, can be readily applied by taxpayers and readily administered by the IRS, and is flexible enough to provide continuing application into the future. In submitting comments, commentators are invited to address any of the definitions included in prior guidance as well as other definitions that have been proposed to the Treasury Department and the IRS by commentators.

In addressing these alternatives, commentators also are invited to discuss how software development efforts that encompass both internal-use software and non-internal use software should be addressed under any particular definition. The Treasury Department and the IRS are concerned that the tendency toward the integration of software across many functions of a taxpayer's business activities may make it difficult for both taxpayers and the IRS to separate internal-use software from non-internal use software (or software not subject to additional qualification requirements) under any particular definition of internal-use software. In addition, the Treasury Department and the IRS are concerned that a definition of internal-use software that relies upon the "primary" or "principal" use of that software would be difficult to apply and administer. The Treasury Department and the IRS' continuing goal is that any final rule must provide clear, objective guidance on what software is treated as internal-use software for purposes of the research credit.

Effective Dates

On **[INSERT DATE FINAL REGULATIONS ARE FILED WITH THE FEDERAL REGISTER]**, the Treasury Department and the IRS published in the **Federal Register** (**XX** FR **XX**) final regulations (TD **XXXX**) relating to the definition of qualified research

under section 41(d). The final regulations apply to taxable years ending on or after **[INSERT DATE FINAL REGULATIONS ARE FILED WITH THE FEDERAL REGISTER]**. The final regulations do not contain final rules for research with respect to computer software "which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" for purposes of section 41(d)(4)(E) (i.e., internal-use software).

The Treasury Department and the IRS have announced in prior guidance, including Notice 87-12 (1987-1 C.B. 432) and more recently in the 2001 proposed regulations, that final regulations relating to internal-use software generally will be effective for taxable years beginning after December 31, 1985. In light of the length of time that has passed since 1986, as well as the developments with respect to computer software discussed in this ANPRM, the Treasury Department and the IRS request comments on whether final regulations relating to internal-use software should have any retroactive effect.

With respect to internal-use software for taxable years beginning after December 31, 1985, and until further guidance is published in the **Federal Register**, taxpayers may continue to rely upon all of the provisions relating to internal-use software in the 2001 proposed regulations (66 FR 66362). Alternatively, taxpayers may continue to rely upon all of the

provisions relating to internal-use software in TD 8930 (66 FR 280). For example, taxpayers relying upon the internal-use software rules of TD 8930 must also apply the "discovery test" as set forth in TD 8930.

Request for Public Comment

The Treasury Department and the IRS invite interested persons to submit comments (in the manner described in the ADDRESSES caption) on issues arising under the provisions for internal-use software. The Treasury Department and the IRS invite comments that address any of the definitions included in prior guidance as well as other definitions that have been proposed to the Treasury Department and the IRS by commentators. Specifically, the Treasury Department and the IRS invite comments that provide a definition of internal-use software that--

1. Appropriately reflects the statute and legislative history;

2. Can be readily applied by taxpayers and readily administered by the IRS; and

3. Is flexible enough to provide continuing application in the future.

Deputy Commissioner for Services and Enforcement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 23, 2003
js-1065

Air Transportation Stabilization Board Statement on Frontier Airlines, Inc. Prepayment of Remaining Loan Balance

The Air Transportation Stabilization Board announced that yesterday, Frontier Airlines, Inc. fully repaid the remaining balance of a $70.0 million loan issued on February 14, 2003. The final payment had been due in 2007. The loan was backed by $63.0 million federal guarantee issued under the Air Transportation Safety and System Stabilization Act.

FROM THE OFFICE OF PUBLIC AFFAIRS

December 24, 2003
2003-12-24-12-26-57-26198

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $86,924 million as of the end of that week, compared to $86,559 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*

	December 12, 2003			December 19, 2003		
TOTAL		86,559			86,924	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	8,211	14,601	22,812	8,281	14,573	22,853
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	13,408	2,933	16,341	13,518	2,927	16,445
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			24,043			24,189
3. Special Drawing Rights (SDRs) [2]			12,319			12,394
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	December 12, 2003			December 19, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						

2.a. Short positions	0		0
2.b. Long positions	0		0
3. Other	0		0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	December 12, 2003			December 19, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions Headquartered in the U.S.						
3.c. With banks and other financial institutions Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be subject to revision. IMF data for the prior week are final.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 29, 2003
js-1066

Treasury Issues Rules To Increase Transparency and Halt Abusive Tax Avoidance Transactions

Reins Tightened on Lawyers, Accountants, and Other Tax Advisors

Today the Treasury Department and the IRS issued four items of administrative guidance as part of their ongoing effort to halt abusive tax avoidance transactions and maximize effective use of IRS audit resources. The first of the items released today is aimed at strengthening the tax system through heightened standards for tax advisors. The other three are aimed at increasing transparency and disclosure of information to the IRS. Improved disclosure coupled with more effective use of the information disclosed are central to the Treasury Department and IRS's strategy for identifying abusive tax avoidance transactions early and addressing them promptly. In addition, the transparency that disclosure brings serves as a deterrent to abusive tax avoidance transactions.

"Taken together, the actions we are announcing today represent another significant step to end the proliferation of abusive tax avoidance transactions that has undermined confidence in our tax system," said Treasury Assistant Secretary for Tax Policy Pam Olson. "We are proposing a set of best practices that makes clear that tax professionals should adhere to the highest ethical standards and ensure that their clients are well-advised of the law and any risks they are taking."

- Proposed changes to Circular 230 that set high standards for the tax advisors and firms that provide opinions supporting tax-motivated transactions.
  - The proposed rules set out clear and specific requirements for tax opinions provided by attorneys and accountants and expectations for those with supervisory responsibility for a professional services firm's tax practice.
  - In an effort to halt the rush to the bottom that pervaded the 1990s and restore the confidence of the public in tax professionals, the proposed changes also describe best practices for tax advisors and call on professional services firms to put in place procedures for all of the firm's personnel that are consistent with these best practices.
  - To ensure clients are well-advised, the proposed changes would obligate tax advisors to inform clients explicitly about what protections, if any, an opinion provides to the client. For example, tax advisors would have to advise clients about issues that the opinion does not address and warn the client if the opinion will not protect the client against penalties.
  - The Treasury Department and the IRS are working with professional organizations to promote best practices among tax professionals through setting aspirational standards and self-regulation. The proposed changes would put in place a framework for that effort.
  - The proposed changes replace changes proposed in January 2001. They reflect a careful consideration of the comments received on the January 2001 proposals and information gathered by the IRS in its audit of professional services firms' compliance with the tax shelter rules.

- Final regulations that will increase the cost of failing to disclose abusive tax avoidance transactions. The regulations also apply to taxpayers who do not disclose that they have reported items on their tax returns that are based on the position that a Treasury regulation is invalid. Under the final regulations, for purposes of the imposition of penalties, a taxpayer's failure to disclose an abusive tax avoidance transaction is treated as a strong indication that the taxpayer acted in bad faith with respect to any additional tax owed as a consequence of the transaction. Similarly, taxpayers who do not disclose items that are based on advice that a Treasury regulation is invalid will be deemed to have acted in bad faith with respect to any additional tax that is

owed as a consequence of those items.

"We are taking the administrative steps we can under current law to create downsides for those who choose not to disclose by making it clear that failing to disclose significantly increases the likelihood of penalties being imposed," continued Assistant Secretary Olson. "Having the IRS hunt for an abusive transaction hidden on a tax return is a waste of IRS resources. If a taxpayer is willing to enter into a transaction, then the taxpayer should be willing to disclose that transaction on its return."

- Revised final regulations clarifying that the disclosure of confidential transactions on a return is limited to transactions for which a promoter has imposed confidentiality on a taxpayer to protect the promoter's tax strategies from disclosure. The revisions are intended to reduce unnecessary paperwork for taxpayers and advisors and to allow the IRS to focus its attention on transactions with potential for abusive tax avoidance, not on transactions for which confidentiality is required for non-tax reasons.

"We continue to believe that sunshine is the best disinfectant for abusive transactions," noted Assistant Secretary Olson." "Ensuring that the rules are focused appropriately on the transactions with potential for abusive tax avoidance will further that goal. Burdening taxpayers and burying the IRS with useless paper will not. As a consequence, we have narrowed the disclosure of confidential transactions to situations in which the promoter imposed confidentiality to keep the promoter's tax strategy out of view."

- Proposed new Form 8858 requiring information reporting by U.S. persons that own foreign entities that are disregarded for U.S. tax purposes. The need for information is not limited to the area of abusive tax avoidance transactions. Appropriately tailored disclosure and information reporting requirements provide the means to better focus the audit resources aimed at protecting the integrity of our tax system. Ready access to information allows the IRS to identify potential compliance issues efficiently and is critical to achieving the IRS's commitment to reducing the time needed to complete an audit. The proposed Form 8858 will be required for annual accounting periods beginning after December 31, 2003. Comments on the text of the proposed new Form 8858 are requested from the public by March 1, 2004.

"Lack of information increases the time it takes for the IRS to identify and address potential compliance issues efficiently and effectively," Assistant Secretary Olson stated. "The proposed new form will increase transparency for offshore entities, allowing the IRS to better focus its resources and improve compliance. The disclosure will also have a deterrent effect."

"The Treasury Department has adopted measures that do as much as possible to stem abusive tax avoidance transactions without legislative change. We urge Congress to pass the legislation the Treasury Department and IRS proposed in March 2002 to deter abusive tax avoidance and facilitate the upfront identification of questionable transactions," concluded Assistant Secretary Olson.

ATTACHED
Circular 230: Regulations Governing Practice before the Internal Revenue Service
6011: Final Regulations Clarifying the Rules Relating to Confidential Transactions
6662-6664: Final Regulations Intended to Promote Disclosure of Reportable Transactions
Announcement 2004-4: Information Reporting With Respect to Foreign Disregarded Entities
Form 8858 (Information Reporting With Respect to Foreign Disregarded Entities)
Schedule M to Form 8858

These will be published in the Federal Register in the next few days and are subject to minor technical changes.

-30-

Related Documents:

- Circular 230: Regulations Governing Practice before the Internal Revenue

Service
- 6011: Final Regulations Clarifying the Rules Relating to Confidential Transactions
- 6662-6664: Final Regulations Intended to Promote Disclosure of Reportable Transactions
- Form 8858 (Information Reporting With Respect to Foreign Disregarded Entities)
- Schedule M to Form 8858
- Announcement 2004-4: Information Reporting With Respect to Foreign Disregarded Entities

[4830-01-p]

DEPARTMENT OF THE TREASURY

Office of the Secretary

31 CFR Part 10

[REG-122379-02]

RIN 1545-BA70

Regulations Governing Practice Before the Internal Revenue Service

AGENCY: Office of the Secretary, Treasury.

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

SUMMARY: This notice proposes modifications of the regulations governing practice before the Internal Revenue Service (Circular 230). These regulations affect individuals who are eligible to practice before the IRS. The proposed modifications set forth best practices for tax advisors providing advice to taxpayers relating to Federal tax issues or submissions to the IRS and modify the standards for certain tax shelter opinions. This document also provides notice of a public hearing regarding the proposed regulations.

DATES: Comments: Written or electronically generated comments must be received by February 13, 2004.

Public hearing: Outlines of topics to be discussed at the public hearing scheduled for February 18, 2004, in the Auditorium of the Internal Revenue Building at 1111 Constitution Avenue, NW., Washington, DC 20224, must be received by February 11, 2004. ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-122379-02), room 5203, Internal Revenue Service, POB 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-122379-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at: www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Concerning issues for comment, Heather L. Dostaler or Bridget E. Tombul at (202) 622-4940; concerning submissions of comments, Guy Traynor of the Publications and Regulations Branch at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507). 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 March 1, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the Office of Professional Responsibility, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proper collection of information (see below);

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 collections of information (disclosure requirements) in these proposed regulations are in Sec. 10.35(d). Section 10.35(d) requires a practitioner providing a tax shelter opinion to make certain disclosures in the beginning of marketed tax shelter opinions, limited scope opinions and opinions that fail to conclude at a confidence level of at least more likely than not. In addition, certain relationships between the practitioner and a person promoting or marketing a tax shelter must be disclosed. A practitioner may be required to make one or more disclosure at the beginning of an opinion. The collection of this material helps to ensure that taxpayers who receive a tax shelter opinion are informed of any facts or circumstances that might limit the taxpayer's use of the opinion. The collection of information is mandatory.

Estimated total annual disclosure burden is 13,333 hours.

Estimated annual burden per disclosing practitioner varies from 5 to 10 minutes, depending on individual circumstances, with an estimated average of 8 minutes.

Estimated number of disclosing practitioners is 100,000.

Estimated annual frequency of responses is on occasion.

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 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 section 6103 of the Internal Revenue Code.

Background

Section 330 of title 31 of the United States Code authorizes the Secretary of the Treasury to regulate the practice of representatives before the Treasury Department. The Secretary has published the regulations in Circular 230 (31 CFR part 10). On February 23, 1984, the regulations were amended to provide standards for tax shelter opinions (49 FR 6719). On May 5, 2000, an advance notice of proposed rulemaking was published (65 FR 30375) which requested comments regarding amendments to the standards of practice governing tax shelters and other general matters. On January 12, 2001, a notice of proposed rulemaking (66 FR 3276) was published that proposed amendments to the regulations relating to practice before the Internal Revenue Service in general and addressing tax shelter opinions in particular. On July 26, 2002, final regulations (67 FR 48760) were issued incorporating only the non-tax shelter related

matters. The IRS and the Treasury Department announced that regulations governing standards for tax shelter opinions would be proposed again at a later date.

This document proposes new proposed amendments to the standards governing tax shelter opinions and withdraws proposed amendments to §§10.33, 10.35 and 10.36 of the regulations governing practice before the IRS that were published in 2001. See 66 FR 3276 (Jan. 12, 2001).

Explanation of Provisions

Tax advisors play an increasingly important role in the Federal tax system, which is founded on principles of voluntary compliance. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice. To restore, promote, and maintain the public's confidence in those individuals and firms, these proposed regulations set forth best practices applicable to all tax advisors. These regulations also amend the mandatory requirements for practitioners who provide certain tax shelter opinions. These regulations are limited to practice before the IRS and do not alter or supplant other ethical standards applicable to practitioners.

The standards set forth in these proposed regulations differ from the January 12, 2001 proposed regulations in several ways. First, §10.33 prescribes best practices for all tax advisors. Second, §10.35 combines and modifies the standards applicable to marketed and more likely than not tax shelter opinions in former §10.33 (tax shelter opinions used to market tax shelters) and former §10.35 (more likely than not tax shelter opinions) of the January 12, 2001 proposed regulations. Third, these regulations revise

proposed §10.36, which provides procedures for ensuring compliance with §§10.33 and 10.35. Finally, provisions relating to advisory committees to the Office of Professional Responsibility are provided in new §10.37. The Treasury Department and the IRS will publish conforming amendments to §§10.22 and 10.52 in a separate notice of proposed rulemaking.

Best Practices

To ensure the integrity of the tax system, tax professionals should adhere to best practices when providing advice or assisting their clients in the preparation of a submission to the IRS. Section 10.33 describes the best practices to be observed by all tax advisors in providing clients with the highest quality representation. These best practices include: (1) communicating clearly with the client regarding the terms of the engagement and the form and scope of the advice or assistance to be rendered; (2) establishing the relevant facts, including evaluating the reasonableness of any assumptions or representations; (3) relating applicable law, including potentially applicable judicial doctrines, to the relevant facts; (4) arriving at a conclusion supported by the law and the facts; (5) advising the client regarding the import of the conclusions reached; and (6) acting fairly and with integrity in practice before the IRS.

Standards for Certain Tax Shelter Opinions

Section 10.35 prescribes requirements for practitioners providing more likely than not and marketed tax shelter opinions. A more likely than not tax shelter opinion is a tax shelter opinion that reaches a conclusion of at least more likely than not with respect to one or more material Federal tax issue(s). A marketed tax shelter opinion is a tax

shelter opinion, including a more likely than not tax shelter opinion, that a practitioner knows, or has reason to know, will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending a tax shelter to one or more taxpayers.

Definition of Tax Shelter Opinion

These proposed regulations retain the definition of tax shelter proposed in January 2001 by applying the definition found in section 6662 to all taxes under the Internal Revenue Code. A number of commentators expressed concern that this definition is overly broad, encompasses routine tax matters, and is difficult to administer by practitioners and the IRS. After careful consideration of these issues, the Treasury Department and the IRS have determined that the definition in the proposed regulations best defines the scope of these regulations. Section 10.35 has been modified, however, to address commentators' concerns by excluding from the definition of a tax shelter opinion preliminary advice provided pursuant to an engagement in which the practitioner is expected subsequently to provide an opinion that satisfies the requirements of this section. In addition, under §10.35(a)(3)(ii), a practitioner may provide an opinion that is limited to some, but not all, material Federal tax issues that may be relevant to the treatment of a tax shelter item if the taxpayer and the practitioner agree to limit the scope of the opinion. Such a limited scope opinion cannot be a marketed tax shelter opinion, and all limited scope opinions must contain the appropriate disclosures described below.

Requirements for Tax Shelter Opinions

The requirements for all more likely than not and marketed tax shelter opinions include: (1) identifying and considering all relevant facts and not relying on any unreasonable factual assumptions or representations; (2) relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts and not relying on any unreasonable legal assumptions, representations or conclusions; (3) considering all material Federal tax issues and reaching a conclusion, supported by the facts and the law, with respect to each material Federal tax issue; and (4) providing an overall conclusion as to the Federal tax treatment of the tax shelter item or items and the reasons for that conclusion.

In addition to the exception to the requirements for limited scope opinions discussed above, in the case of a marketed tax shelter opinion, a practitioner is not expected to identify and ascertain facts peculiar to a taxpayer to whom the transaction is marketed, but the opinion must include the appropriate disclosure described below. Moreover, if a practitioner is unable to reach a conclusion with respect to one or more material Federal tax issue(s) or to reach an overall conclusion in a tax shelter opinion, the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues or to reach an overall conclusion and describe the reasons that the practitioner is unable to reach such a conclusion. If the practitioner fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more material Federal tax issue(s), the opinion must include the appropriate disclosures described below.

Required Disclosures

Section 10.35(d) provides disclosures that are required to be made in the beginning of marketed tax shelter opinions, limited scope opinions, and opinions that fail to reach a conclusion at a confidence level of at least more likely than not. In addition, certain relationships between the practitioner and a person promoting or marketing a tax shelter must be disclosed. A practitioner may be required to make more than one of the disclosures described below.

1. Relationship Between Practitioner and Promoter

Under §10.35(d)(1), a practitioner must disclose if the practitioner has a compensation arrangement with any person (other than the client for whom the opinion is prepared) with respect to the promoting, marketing or recommending of a tax shelter discussed in the opinion. A practitioner also must disclose if there is any referral agreement between the practitioner and any person (other than the client for whom the opinion is prepared) engaged in the promoting, marketing or recommending of the tax shelter discussed in the opinion.

2. Marketed Tax Shelter Opinion

Under §10.35(d)(2), a practitioner must disclose that a marketed opinion may not be sufficient for a taxpayer to use for the purpose of avoiding penalties under section 6662(d) of the Code. The practitioner also must state that taxpayers should seek advice from their own tax advisors.

3. Limited Scope Opinion

Under §10.35(d)(3), a practitioner must disclose in a limited scope opinion that additional issue(s) may exist that could affect the Federal tax treatment of the tax shelter addressed in the opinion, that the opinion does not consider or reach a conclusion with respect to those additional issues and that the opinion was not written, and cannot be used by the recipient, for the purpose of avoiding penalties under section 6662(d) of the Code with respect to those issues outside the scope of the opinion.

4. Opinions That Fail to Reach a Conclusion at a Confidence Level of at Least More Likely Than Not

Under §10.35(d)(4), a practitioner must disclose that the opinion fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more material Federal tax issue(s) addressed by the opinion and that the opinion was not written, and cannot be used by the recipient, for the purpose of avoiding penalties under section 6662(d) of the Code with respect to such issue(s).

Procedures to Ensure Compliance

Section 10.36 provides that tax advisors with responsibility for overseeing a firm's practice before the IRS should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices described in §10.33. In the case of tax shelter opinions, a practitioner with this oversight responsibility must take reasonable steps to ensure that the firm has adequate procedures in effect for purposes of complying with §10.35.

Advisory Committees on the Integrity of Tax Professionals

Section 10.37 authorizes the Director of the Office of Professional Responsibility to establish one or more advisory committees composed of at least five individuals authorized to practice before the IRS. Under procedures prescribed by the Director and at the request of the Director, an advisory committee may review and make recommendations regarding professional standards or best practices for tax advisors or may advise the Director whether a practitioner may have violated §§10.35 or 10.36.

Proposed Effective Date

These regulations are proposed to apply on the date that final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Persons authorized to practice before the IRS have long been required to comply with certain standards of conduct. The added disclosure requirements for tax shelter opinions imposed by these regulations will not have a significant economic impact on a substantial number of small entities because, as previously noted, the estimated burden of disclosures is minimal. This is because practitioners have the information needed to determine whether some of the disclosures are required before the opinion is prepared and for the other disclosures the regulations provide practitioners with the language to

be included in the opinion. 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 notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before the regulations are adopted as final regulations, consideration will be given to any written comments and electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

The public hearing is scheduled for February 18, 2004, at 10 a.m., and will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. All visitors must present photo identification to enter the building. Visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by February 13, 2004, and submit an outline of the topics to be discussed and the time to

be devoted to each topic by February 11, 2004. A period of 10 minutes will be allocated to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of the regulations are Heather L. Dostaler, Bridget E. Tombul, and Brinton T. Warren of the Office of the Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division, but other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 31 CFR Part 10

Administrative practice and procedure, Lawyers, Accountants, Enrolled agents, Enrolled actuaries, Appraisers.

Proposed Amendments to the Regulations

Accordingly, 31 CFR part 10 is proposed to be amended as follows

Paragraph 1. The authority citation for subtitle A, part 10 continues to read as follows:

[Authority: Sec. 3, 23 Stat. 258, secs. 2-12, 60 Stat. 237 et.seq.; 5 U.S.C. 301, 500, 551-559; 31 U.S.C. 330; Reorg. Plan No. 26 of 1950, 15 FR 4935, 64 Stat. 1280, 3 CFR, 1949-1953 Comp., P. 1017.]

PART 10--PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

Par. 2. Section 10.33 is revised to read as follows:

§10.33 Best practices for tax advisors.

(a) Best practices. Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. Best practices include the following:

(1) Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

(2) Establishing the facts, determining which facts are relevant, and evaluating the reasonableness of any assumptions or representations.

(3) Relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts.

(4) Arriving at a conclusion supported by the law and the facts.

(5) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid penalties for a substantial understatement of income tax under section 6662(d) of the Internal Revenue Code if a taxpayer acts in reliance on the advice.

(6) Acting fairly and with integrity in practice before the Internal Revenue Service.

(b) Effective date. This section is effective on the date that final regulations are published in the Federal Register.

Par. 3. Section 10.35 is added to read as follows:

§10.35 Requirements for certain tax shelter opinions.

(a) In general. A practitioner providing a more likely than not tax shelter opinion or a marketed tax shelter opinion must comply with each of the following requirements.

(1) Factual matters. (i) The practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and determine which facts are relevant. The opinion must identify and consider all relevant facts.

(ii) The practitioner must not base the opinion on any unreasonable factual assumptions (including assumptions as to future events), such as a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits, or to make an assumption with respect to a material valuation issue. In the case of any marketed tax shelter opinion, the practitioner is not expected to identify or ascertain facts peculiar to a taxpayer to whom the transaction may be marketed, but the opinion must include the appropriate disclosure(s) required under paragraph (d) of this section.

(iii) The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person, such as a factual representation that the practitioner knows or should know is incorrect or

incomplete. For example, a practitioner may not rely on a taxpayer's factual representation that a transaction has a business purpose if the representation fails to include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete.

(2) Relate law to facts. (i) The practitioner must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.

(ii) The practitioner must not assume the favorable resolution of any material Federal tax issue except as provided in paragraphs (a)(3)(ii) and (b) of this section, or otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions.

(iii) The practitioner's opinion must not contain internally inconsistent legal analyses or conclusions.

(3) Evaluation of material Federal tax issues. (i) The practitioner must consider all material Federal tax issues except as provided in paragraphs (a)(3)(ii) and (b) of this section.

(ii) The practitioner may provide an opinion that considers less than all of the material Federal tax issues if--

(A) The taxpayer and the practitioner agree to limit the scope of the opinion to one or more Federal tax issue(s);

(B) The opinion is not a marketed tax shelter opinion; and

(C) The opinion includes the appropriate disclosure(s) required under paragraph (d) of this section.

(iii) The practitioner must provide his or her conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each material Federal tax issue. If the practitioner is unable to reach a conclusion with respect to one or more material Federal tax issue(s), the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues. The practitioner must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that the practitioner is unable to reach a conclusion as to one or more material Federal tax issue(s). If the practitioner fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more material Federal tax issue(s), the opinion must include the appropriate disclosure(s) required under paragraph (d) of this section.

(iv) The practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled.

(4) Overall conclusion. The practitioner must provide an overall conclusion as to the likelihood that the Federal tax treatment of the tax shelter item or items is the proper treatment and the reasons for that conclusion. If the practitioner is unable to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and describe the reasons for the practitioner's inability to reach a conclusion.

(b) Competence to provide opinion; reliance on opinions of others. (1) The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered. If the practitioner is not sufficiently knowledgeable to

render an informed opinion with respect to particular material Federal tax issues, the practitioner may rely on the opinion of another practitioner with respect to these issues unless the practitioner knows or should know that such opinion should not be relied on. If a practitioner relies on the opinion of another practitioner, the relying practitioner must identify the other opinion and set forth the conclusions reached in the other opinion.

(2) The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, satisfies the requirements of this section.

(c) Definitions. For purposes of this section--

(1) A practitioner includes any individual described in §10.2(e).

(2) The term tax shelter includes any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code. A tax shelter may give rise to one or more tax shelter items.

(3) A tax shelter item is, with respect to a tax shelter, an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property.

(4) Tax shelter opinion--(i) In general. A tax shelter opinion is written advice by a practitioner concerning the Federal tax aspects of any Federal tax issue relating to a tax shelter item or items.

(ii) Excluded advice. A tax shelter opinion does not include written advice provided to a client during the course of an engagement pursuant to which the practitioner is expected subsequently to provide written advice to the client that satisfies

the requirements of this section, or written advice concerning the qualification of a qualified plan.

(iii) Included advice. A tax shelter opinion includes the Federal tax aspects or tax risks portion of offering materials prepared by or at the direction of a practitioner. Similarly, a financial forecast or projection prepared by or at the direction of a practitioner is a tax shelter opinion if it is predicated on assumptions regarding Federal tax aspects of the investment.

(5) A more likely than not tax shelter opinion is a tax shelter opinion that reaches a conclusion at a confidence level of at least more likely than not (that is, greater than 50 percent) that one or more material Federal tax issues would be resolved in the taxpayer's favor.

(6) A marketed tax shelter opinion is a tax shelter opinion, including a more likely than not tax shelter opinion, that a practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending the tax shelter to one or more taxpayers.

(7) A material Federal tax issue is any Federal tax issue for which the Internal Revenue Service has a reasonable basis for a successful challenge and the resolution of which could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the Federal tax treatment of a taxpayer's tax shelter item or items.

(d) Required disclosures. An opinion must contain all of the following disclosures that apply--(1) Relationship between promoter and practitioner. A practitioner must disclose in the beginning of the opinion the existence of--

(i) Any compensation arrangement, such as a referral fee or a fee-sharing arrangement, between the practitioner (or the practitioner's firm) and any person (other than the client for whom the opinion is prepared) with respect to the promoting, marketing or recommending of a tax shelter discussed in the opinion; or

(ii) Any referral agreement between the practitioner (or the practitioner's firm) and a person (other than the client for whom the opinion is prepared) engaged in the promoting, marketing or recommending of the tax shelter discussed in the opinion.

(2) Marketed tax shelter opinions. A practitioner must disclose in the beginning of a marketed tax shelter opinion that with respect to any material Federal tax issue for which the opinion reaches a conclusion at a confidence level of at least more likely than not--

(i) The opinion may not be sufficient for a taxpayer to use for the purpose of avoiding penalties relating to a substantial understatement of income tax under section 6662(d) of the Internal Revenue Code; and

(ii) Taxpayers should seek advice based on their individual circumstances with respect to those material Federal tax issues from their own tax advisor(s).

(3) Limited scope opinions. If a practitioner provides an opinion that is limited to one or more Federal tax issue(s) agreed to by the taxpayer and the practitioner, the practitioner must disclose in the beginning of the opinion that--

(i) The opinion is limited to the one or more Federal tax issue(s) agreed to by the taxpayer and the practitioner and addressed in the opinion;

(ii) Additional issue(s) may exist that could affect the Federal tax treatment of the tax shelter addressed in the opinion and the opinion does not consider or provide a conclusion with respect to any additional issue(s); and

(iii) With respect to any material Federal tax issue(s) outside the limited scope of the opinion, the opinion was not written, and cannot be used by the recipient, for the purpose of avoiding penalties relating to a substantial understatement of income tax under section 6662(d) of the Internal Revenue Code.

(4) Opinions that fail to reach a more likely than not conclusion. If a practitioner does not reach a conclusion at a confidence level of at least more likely than not with respect to a material Federal tax issue addressed by the opinion, the practitioner must disclose in the beginning of the opinion that--

(i) The opinion does not reach a conclusion at a confidence level of at least more likely than not that with respect to one or more material Federal tax issues addressed by the opinion; and

(ii) With respect to those material Federal tax issues, the opinion was not written, and cannot be used by the recipient, for the purpose of avoiding penalties relating to a substantial understatement of income tax under section 6662(d) of the Internal Revenue Code.

(e) Effect of opinion that meets these standards. An opinion that meets these requirements satisfies the practitioner's responsibilities under this section, but the

persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be separately determined under applicable provisions of the law and regulations.

(f) Effective date. This section applies to tax shelter opinions rendered after the date that final regulations are published in the **Federal Register**.

Par. 4. Section 10.36 is added to read as follows:

§10.36 Procedures to ensure compliance.

(a) Best practices for tax advisors. Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices described in §10.33.

(b) Requirements for certain tax shelter opinions. Any practitioner who has (or practitioners who have or share) principal authority and responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with §10.35. A practitioner will be subject to discipline for failing to comply with the requirements of this paragraph if--

(1) The practitioner through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with §10.35, and one or more individuals who are members of, associated with,

or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with §10.35; or

(2) The practitioner knows or has reason to know that one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a practice, in connection with their practice with the firm, that does not comply with §10.35 and the practitioner, through willfulness, recklessness, or gross incompetence fails to take prompt action to correct the noncompliance.

(c) Effective date. Paragraph (a) of this section is effective on the date that final regulations are published in the **Federal Register**. Paragraph (b) of this section applies to tax shelter opinions rendered after the date that final regulations are published in the **Federal Register**.

Par. 5. Section 10.37 is added to read as follows:

§10.37 Establishment of Advisory Committees.

(a) Advisory committees. To promote and maintain the public's confidence in tax advisors, the Director of the Office of Professional Responsibility is authorized to establish one or more advisory committees composed of at least five individuals authorized to practice before the Internal Revenue Service. Under procedures prescribed by the Director, an advisory committee may review and make recommendations regarding professional standards or best practices for tax advisors, or more particularly, whether a practitioner may have violated §§10.35 or 10.36.

(b) Effective date. This section is effective on the date that final regulations are published in the **Federal Register**.

Par. 6. Section 10.93 is revised to read as follows:

§ 10.93 Effective date.

Except as otherwise provided in each section and subject to §10.91, Part 10 is applicable on July 26, 2002.

Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

Approved: December 19, 2003

George B. Wolfe

Deputy General Counsel, Office of the Secretary.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

[TD 9108]

RIN 1545-BC76

Confidential Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: These final regulations modify and clarify the rules relating to confidential transactions under the Income Tax Regulations, and make minor conforming changes to the list maintenance rules under the Procedure and Administration Regulations. These regulations affect taxpayers participating in reportable transactions and persons responsible for maintaining and furnishing lists of investors in reportable transactions.

DATES: Effective Date: These regulations are effective December 29, 2003.

Applicability Dates: For dates of applicability, see §1.6011-4(h) and §301.6112-1.

FOR FURTHER INFORMATION CONTACT: Tara P. Volungis or Charlotte Chyr, 202-622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these regulations have been previously 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 numbers 1545-1685 and 1545-1686.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number 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 amends 26 CFR parts 1 and 301 by modifying and clarifying the rules relating to the disclosure of reportable transactions by certain taxpayers on their Federal income tax returns under section 6011 and by making conforming changes to the rules under section 6112.

On October 17, 2002, the IRS issued temporary and proposed regulations modifying the rules under sections 6011,

6111, and 6112 (TD 9017, REG-103735-00, REG-154117-02, REG-154116-02, REG-154115-02, REG-154429-02, REG-154423-02, REG-154426-02, REG-110311-98; TD 9018, REG-103736-00) (the October 2002 regulations). The October 2002 regulations were published in the **Federal Register** (67 FR 64799, 67 FR 64840; 67 FR 64807, 67 FR 64842) on October 22, 2002. On December 11, 2002, and on January 7, 2003, the IRS and Treasury Department held a public hearing on these regulations. On February 28, 2003, the IRS issued final regulations under sections 6011, 6111, and 6112 (TD 9046) (the February 2003 regulations). The February 2003 regulations were published in the **Federal Register** (68 FR 10161) on March 4, 2003.

Since finalizing the disclosure regulations, the IRS and Treasury Department have received numerous comments concerning the confidentiality filter. The IRS and Treasury Department received requests to exclude certain transactions from the scope of the confidentiality filter, and requests to modify the language of the regulation itself. After reviewing these comments, the IRS and Treasury Department have decided to narrow the confidentiality filter under §1.6011-4(b)(3).

Explanation of Provisions

Section 1.6011-4(b)(3) provides that certain transactions are identified as confidential transactions. Confidential

transactions are reportable transactions that are subject to the disclosure rules under §1.6011-4 and the list maintenance rules under §301.6112-1. Currently, a confidential transaction is a transaction that is offered under conditions of confidentiality. The confidentiality filter generally provides a presumption of non-confidentiality if the taxpayer receives written authorization to disclose the tax treatment and tax structure of the transaction.

The IRS and Treasury Department have concluded that the confidentiality filter should be limited to situations in which an advisor is paid a large fee and imposes a limitation on disclosure that protects the confidentiality of the advisor's tax strategies. The IRS and Treasury Department believe that the confidentiality filter should not apply to transactions in which confidentiality is imposed by a party to the transaction acting in such capacity. Accordingly, the confidentiality filter has been narrowed to reflect this policy. Further, the exceptions and presumption language have been removed because the IRS and Treasury Department have concluded that they no longer are necessary under this narrower rule. Conforming changes have been made to the rules under §301.6112-1.

The IRS and Treasury Department also have made minor

clarifying changes under §1.6011-4. The regulations clarify that a return includes amended returns for purposes of determining when a disclosure must be made. The IRS and Treasury Department will continue to accept comments and will make other changes as appropriate.

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 been determined pursuant to 5 U.S.C. 553(b)(B) that notice and public procedure are unnecessary and contrary to the public interest. These final regulations substantially reduce taxpayer compliance burdens by limiting the scope of transactions subject to the disclosure requirements of §1.6011-4. For the same reason, pursuant to 5 U.S.C. 553(d)(1) and (3) a delayed effective date for these final regulations is not required. Because no notice of proposed rulemaking is required, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. However, the IRS and Treasury Department welcome comments on whether these final regulations impose additional costs and compliance burdens on small businesses. Any such comments should provide specific information concerning those costs and burdens. In

addition, the IRS and Treasury Department will consider holding a public hearing concerning these regulations if there is sufficient interest from affected parties. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Tara P. Volungis and Charlotte Chyr, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Administrative practice and procedure, Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are 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 1.6011-4 is amended as follows:

1. Paragraph (b)(3) is revised.

2. Paragraph (e)(1) is amended by removing the second sentence and replacing it with two new sentences in its place.

3. Paragraphs (e)(2)(i) and (h) are revised.

The revisions and additions read as follows:

§1.6011-4 Requirement of statement disclosing participation in certain transactions by taxpayers.

* * * * *

(b) * * * * *

(3) Confidential transactions--(i) In general. A confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee.

(ii) Conditions of confidentiality. A transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the

limitation on disclosure protects the confidentiality of that advisor's tax strategies. A transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer. A claim that a transaction is proprietary or exclusive is not treated as a limitation on disclosure if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.

(iii) Minimum fee. For purposes of this paragraph (b)(3), the minimum fee is:

(A) $250,000 for a transaction if the taxpayer is a corporation.

(B) $50,000 for all other transactions unless the taxpayer is a partnership or trust, all of the owners or beneficiaries of which are corporations (looking through any partners or beneficiaries that are themselves partnerships or trusts), in which case the minimum fee is $250,000.

(iv) Determination of minimum fee. For purposes of this paragraph (b)(3), a minimum fee includes all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction. These fees include consideration in whatever form paid, whether in cash or in kind, for services to analyze the transaction

(whether or not related to the tax consequences of the transaction), for services to implement the transaction, for services to document the transaction, and for services to prepare tax returns to the extent that the fees exceed the fees customary for return preparation. For purposes of this paragraph (b)(3), a taxpayer also is treated as paying fees to an advisor if the taxpayer knows or should know that the amount it pays will be paid indirectly to the advisor, such as through a referral fee or fee-sharing arrangement. A fee does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property.

(v) Related parties. For purposes of this paragraph (b)(3), persons who bear a relationship to each other as described in section 267(b) or 707(b) will be treated as the same person.

* * * * *

(e) * * *

(1) * * * In addition, the disclosure statement for a reportable transaction must be attached to each amended return that reflects a taxpayer's participation in a reportable transaction. A copy of the disclosure statement must be sent

to OTSA at the same time that any disclosure statement is first filed by the taxpayer. * * *

(2) * * *

(i) <u>Listed transactions</u>. If a transaction becomes a listed transaction after the filing of a taxpayer's tax return (including an amended return) reflecting either tax consequences or a tax strategy described in the published guidance listing the transaction (or a tax benefit derived from tax consequences or a tax strategy described in the published guidance listing the transaction) and before the end of the period of limitations for the final return (whether or not already filed) reflecting the tax consequences, tax strategy, or tax benefit, then a disclosure statement must be filed as an attachment to the taxpayer's tax return next filed after the date the transaction is listed regardless of whether the taxpayer participated in the transaction in that year.

* * * * *

(h) <u>Effective dates</u>. This section applies to Federal income tax returns filed after February 28, 2000. However, paragraphs (b)(3), (e)(1), and (e)(2)(i) of this section apply to transactions entered into on or after December 29, 2003. All the rules in this section may be relied upon for transactions entered into on or after January 1, 2003, and

before December 29, 2003. Otherwise, the rules that apply with respect to transactions entered into before December 29, 2003 are contained in §1.6011-4 in effect prior to December 29, 2003, (see 26 CFR part 1 revised as of April 1, 2003).

PART 301--PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

Par. 4. In §301.6112-1, paragraph (c)(3)(iii) is amended by revising the first sentence, removing the words "for advice or implementation" from the third sentence, and adding two sentences after the third sentence, to read as follows:

§301.6112-1 Requirement to prepare, maintain, and furnish lists with respect to potentially abusive tax shelters.

* * * * *

(c) * * *

(3) * * *

(iii) * * * In determining whether the minimum fee threshold is satisfied, all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction that is a potentially abusive tax shelter are taken

into account. * * * A fee does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property. * * *

* * * * *

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2003

/s/ Pamela F. Olson

Assistant Secretary of the Treasury.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9109]

RIN 1545-AY97

Establishing Defenses to the Imposition of the Accuracy-Related Penalty

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that affect the defenses available to the imposition of the accuracy-related penalty when taxpayers fail to disclose reportable transactions or fail to disclose that they have taken a return position based on the conclusion that a regulation is invalid. The final regulations are intended to promote disclosure of reportable transactions and positions based on the conclusion that a regulation is invalid by narrowing a taxpayer's ability to establish good faith and reasonable cause as a defense. The final regulations also clarify the existing regulations with respect to the facts and circumstances to be considered in determining whether a taxpayer acted with reasonable cause and in good faith.

DATES: Effective Dates: These regulations are effective December 30, 2003.

Applicability Dates: These regulations apply to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003.

FOR FURTHER INFORMATION CONTACT: Jamie G. Bernstein at (202) 622-4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1. On December 31, 2002, the IRS and the Treasury Department published in the **Federal Register** (67 FR 79894) proposed amendments to the regulations (REG-126016-01) under sections 6662 and 6664 of the Internal Revenue Code (Code). No public hearing was requested or held. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations under section 6662 and 6664 are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Revisions and Summary of Comments

These final regulations generally adopt the provisions of the proposed regulations. The changes to the proposed regulations reflected in these final regulations, as well as comments received, are discussed below.

1. Applicability of Disclosure Regulations Under Section 6011 and Effective Date

These final regulations were proposed to apply to returns filed after December 30, 2002, with respect to transactions entered into on or after January 1, 2003, to coincide with temporary regulations relating to disclosure, promulgated under section 6011 and applicable for transactions entered into on or after January 1, 2003 (the Temporary Disclosure Regulations). The Temporary Disclosure Regulations were published in the **Federal Register** on October 22, 2002. See 67 FR 64799 and 67 FR 64840 (October 22, 2002). Final regulations under section 6011 were published on March 4, 2003, and apply to transactions entered into on or after February 28, 2003.

See 68 FR 10161, 10163 (March 4, 2003) (the Final Disclosure Regulations). The Final Disclosure Regulations define reportable transactions more narrowly than the Temporary Disclosure Regulations. For transactions entered into on or after January 1, 2003, and before February 28, 2003, the taxpayer may apply the Final Disclosure Regulations instead of the Temporary Disclosure Regulations. Revisions throughout these final regulations refer to the definition of reportable transaction in §1.6011-4(b) or 1.6011-4T(b), as applicable, to accommodate situations in which the Temporary Disclosure Regulations apply to a transaction.

One commentator suggested that the final regulations under sections 6662 and 6664 apply to transactions entered into on or after February 28, 2003, because that date is the effective date for the Final Disclosure Regulations. See 68 FR 10161, 10163 (March 4, 2003). The final regulations do not adopt this recommendation. The proposed regulations under sections 6662 and 6664 provided adequate notice that failure to comply with the Temporary or Final Disclosure Regulations could limit the penalty defenses available under sections 6662 and 6664.

2. Applicability of the Reasonable Cause and Good Faith Defense

The proposed regulations prohibited reliance on tax advice to establish a reasonable cause and good faith defense to the accuracy-related penalties if a taxpayer failed to disclose a reportable transaction pursuant to the Final or Temporary Disclosure Regulations, as applicable. Three commentators suggested that it is inappropriate to preclude a taxpayer from relying on the advice of a tax advisor in circumstances in which the taxpayer does not lack good faith in failing to disclose a reportable transaction. The Treasury Department and the IRS believe that good faith requires

taxpayers to be forthcoming and that taxpayers should construe the Final and Temporary Disclosure Regulations broadly in favor of disclosure. Nonetheless, there may be circumstances in which a taxpayer does not lack good faith in failing to disclose a reportable transaction. Accordingly, the final regulations revise the proposed regulations to provide that a taxpayer's failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith, which would bar relief under section 6664(c).

These final regulations also adopt the requirement in the proposed regulations that a taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and in good faith unless the taxpayer adequately disclosed its position that the regulation is invalid. One commentator suggested that this provision is inappropriate because it would be difficult for a taxpayer to discern whether its position is contrary to a regulation without consulting with a tax advisor. This suggestion was rejected because the requirement of revised §1.6664-4(c)(2)(iii) does not apply to situations in which a taxpayer has taken a position that is merely contrary to a regulation, but instead applies to situations in which a taxpayer has taken a return position based on advice or an opinion that a regulation is invalid.

3. <u>Definition of Advice</u>

One commentator suggested that the proposed regulations more clearly define what constitutes professional advice or opinion. Section 1.6664-4(c)(2) defines the term

advice. Neither the proposed nor the final regulations change the definition of the term advice.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information 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 proposed regulations 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 these regulations is Jamie Bernstein, Office of the Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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 1.6662-0 is amended by adding an entry for §1.6662-2(d)(5) to read as follows:

§1.6662-0 Table of Contents.

* * * * *

§1.6662-2 Accuracy-related penalty.

* * * * *

(d) * * *

(5) Returns filed after December 31, 2002.

* * * * *

Par. 3. Section 1.6662-2 is amended by:

1. Revising the first sentence of paragraph (d)(2).

2. Adding new paragraph (d)(5).

The revision and addition read as follows:

§1.6662-2 Accuracy-related penalty.

* * * * *

(d) * * * (1) * * *

(2) * * * Except as provided in paragraphs (d)(3), (4) and (5) of this section and the last sentence of this paragraph (d)(2), the provisions of §§1.6662-1 through 1.6662-4 and §1.6662-7 (as revised to reflect the changes made to the accuracy-related penalty by the Omnibus Budget Reconciliation Act of 1993) and of §1.6662-5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1993. * * *

* * * * *

(5) For returns filed after December 31, 2002. Sections 1.6662-3(a), 1.6662-3(b)(2) and 1.6662-3(c)(1) (relating to adequate disclosure) apply to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1,

003. Except as provided in paragraph (d)(1) of this section, §§1.6662-3(a), 1.6662-
(b)(2) and 1.6662-3(c)(1) (as contained in 26 CFR part 1 revised April 1, 2003) apply to
›turns filed with respect to transactions entered into prior to January 1, 2003.

Par. 4. Section 1.6662-3 is amended by revising paragraph (a), the last
›ntence of paragraph (b)(2), and the first sentence of paragraph (c)(1) to read as
llows:

|.6662-3 Negligence or disregard of rules or regulations.

(a) In general. If any portion of an underpayment, as defined in section 6664(a)
ıd §1.6664-2, of any income tax imposed under subtitle A of the Internal Revenue
›de that is required to be shown on a return is attributable to negligence or disregard
rules or regulations, there is added to the tax an amount equal to 20 percent of such
rtion. The penalty for disregarding rules or regulations does not apply, however, if the
quirements of paragraph (c)(1) of this section are satisfied and the position in question
adequately disclosed as provided in paragraph (c)(2) of this section (and, if the
sition relates to a reportable transaction as defined in §1.6011-4(b) (or §1.6011-4T(b),
applicable), the transaction is disclosed in accordance with §1.6011-4 (or §1.6011-
, as applicable)), or to the extent that the reasonable cause and good faith exception
this penalty set forth in §1.6664-4 applies. In addition, if a position with respect to an
n (other than with respect to a reportable transaction, as defined in §1.6011-4(b) or
6011-4T(b), as applicable) is contrary to a revenue ruling or notice (other than a
ice of proposed rulemaking) issued by the Internal Revenue Service and published in
Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), this penalty does not
›ly if the position has a realistic possibility of being sustained on its merits. See

§1.6694-2(b) of the income tax return preparer penalty regulations for a description of the realistic possibility standard.

(b)* * * * *

(2)* * *Nevertheless, a taxpayer who takes a position (other than with respect to a reportable transaction, as defined in §1.6011-4(b) or §1.6011-4T(b), as applicable) contrary to a revenue ruling or notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.

* * * * *

(c)* * *(1) * * * No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in §1.6011-4(b) (or §1.6011-4T(b), as applicable), the transaction is disclosed in accordance with §1.6011-4 (or §1.6011-4T, as applicable)) and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation. * * *

* * * * *

§1.6662-4 [Amended]

Par. 5. Section 1.6662-4(g)(1)(iv) is amended by removing the reference to "§1.6664-4(e)" and adding the reference "§1.6664-4(f)" in its place.

Par. 6. Section 1.6664-0 is amended by:

1. Adding entries for §§1.6664-1 (b)(2)(i), (b)(2)(ii) and 1.6664-4(c)(1)(iii).

2. Redesignating the entries for §1.6664-4(d), (e), (f), and (g), as §1.6664-4(e), (f), (g), and (h), respectively.

3. Adding a new entry for §1.6664-4(d).

The additions read as follows:

§1.6664-0 Table of contents.

* * * * *

§1.6664-1 Accuracy-related and fraud penalties, definitions and special rules.

* * * * *

(b) * * *
(2)* * *
(i) For returns due after September 1, 1995.
(ii) For returns filed after December 31, 2002.

* * * * *

§1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

* * * * *

(c) * * *
(1) * * *
(iii) Reliance on the invalidity of a regulation.
(d) Underpayments attributable to reportable transactions.

* * * * *

Par. 7. Section 1.6664-1 is amended by:

1. Redesignating the text of paragraph (b)(2) as (b)(2)(i)

2. Adding a new paragraph heading for newly designated paragraph (b)(2)(i).

3. Adding paragraph (b)(2)(ii).

The revisions and additions are as follows:

§1.6664-1 Accuracy-related and fraud penalties; definitions and special rules.

* * * * *

(b) * * * (1) * * *

(2)* * *(i) For returns due after September 1, 1995. * * *

(ii) For returns filed after December 31, 2002. Sections 1.6664-4(c) (relating to relying on opinion or advice) and (d) (relating to underpayments attributable to

reportable transactions) apply to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Except as provided in paragraph (b)(2)(i) of this section, §1.6664-4 (as contained in 26 CFR part 1 revised April 1, 2003) applies to returns filed with respect to transactions entered into before January 1, 2003.

Par. 8. Section 1.6664-4 is amended by:

1. Removing the language "(g) of this section" from the last sentence of paragraph (a) and adding the language "(h) of this section" in its place.

2. Revising paragraph (c)(1) introductory text and the last sentence of paragraph (c)(1)(i).

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

4. Redesignating paragraphs (d), (e), (f) and (g) as paragraphs (e), (f), (g) and (h), respectively.

5. Adding a new paragraph (d).

6. Removing the language "(e)" wherever it appears in newly designated paragraphs (f)(1), (f)(2)(i), (f)(2)(ii), (f)(3), and (f)(4) and adding the language "(f)" in its place.

7. Removing the language "(g)" wherever it appears in newly designated paragraphs (h)(1), (h)(1)(i), (h)(2), and (h)(3) and adding the language "(h)" in its place.

The revisions and additions read as follows:

§1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

* * * * *

(c) Reliance on opinion or advice--(1) Facts and circumstances; minimum requirements. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) * * * In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

* * * * *

(iii) Reliance on the invalidity of a regulation. A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with

reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with §1.6662-3(c)(2), the position that the regulation in question is invalid.

(d) Underpayments attributable to reportable transactions. If any portion of an underpayment is attributable to a reportable transaction, as defined in §1.6011-4(b) (or §1.6011-4T(b), as applicable), then failure by the taxpayer to disclose the transaction in accordance with §1.6011-4 (or §1.6011-4T, as applicable) is a strong indication that the

taxpayer did not act in good faith with respect to the portion of the underpayment attributable to the reportable transaction.

* * * * *

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2003

/s/ Pamela F. Olson

Assistant Secretary of the Treasury.

Form **8858**

(December 2004)

Department of the Treasury
Internal Revenue Service

Information Return of U.S. Persons With Respect To Foreign Disregarded Entities

▶ **See separate instructions.**

Information furnished for the foreign disregarded entity's annual accounting period (see instructions) beginning , 20 , and ending , 20

OMB No. 1545-XXXX

Name of person filing this return

Filer's identifying number

Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)

City or town, state, and ZIP code

Filer's tax year beginning , 20 , and ending , 20

Important: *Fill in all applicable lines and schedules. All information* ***must*** *be in English. All amounts* ***must*** *be stated in U.S. dollars unless otherwise indicated.*

1a Name and address of foreign disregarded entity

b U.S. identifying number, if any

c Country(ies) under whose laws organized and entity type under local tax law

d Date(s) of organization

e Effective date as foreign disregarded entity

f If benefits under a U.S. tax treaty were claimed with respect to income of the foreign disregarded entity, enter the treaty and article number

g Country in which principal business activity is conducted

h Principal business activity

i Functional currency

2 Provide the following information for the foreign disregarded entity's accounting period stated above.

a Name, address, and identifying number of branch office or agent (if any) in the United States

b Name and address (including corporate department, if applicable) of person(s) with custody of the books and records of the foreign disregarded entity, and the location of such books and records, if different

3 For the **tax owner** of the foreign disregarded entity (if different from the filer) provide the following:

a Name and address

b Tax year

c U.S. identifying number, if any

d Country under whose laws organized

e Functional currency

4 For the **direct owner** of the foreign disregarded entity (if different from the tax owner) provide the following:

a Name and address

b Country under whose laws organized

c U.S. identifying number, if any

d Functional currency

5 Provide a list or an organizational chart identifying the name, placement, percentage of ownership, and tax classification of all entities in the chain between the tax owner and the foreign disregarded entity, and all entities in which the foreign disregarded entity has a 10% or more direct or indirect interest. See instructions.

Schedule C — Income Statement (see page XX of the instructions)

Important: *Report all information in functional currency in accordance with U.S. GAAP. Also, report each amount in U.S. dollars translated from functional currency (using GAAP translation rules). However, if the functional currency is the U.S. dollar, complete only the U.S. Dollars column. See instructions for special rules for foreign disregarded entities that use DASTM.*

			Functional Currency	U.S. Dollars
1	Gross receipts or sales (net of returns and allowances)	1		
2	Cost of goods sold	2		
3	Gross profit (subtract line 2 from line 1)	3		
4	Other income	4		
5	Total income (add lines 3 and 4)	5		
6	Total deductions	6		
7	Other adjustments	7		
8	Net income (loss) per books	8		

Schedule C-1 Section 987 Gain or Loss Information

			Amount stated in functional currency of foreign disregarded entity	Amount stated in functional currency of recipient
1	Remittances from the foreign disregarded entity	1		
2	Section 987 gain (loss) of recipient	2		

		Yes	No
3	Were all remittances from the foreign disregarded entity reflected on the books of the direct owner?		
4	Did the tax owner change its method of accounting for section 987 gain or loss with respect to remittances from the foreign disregarded entity during the tax year?		

Schedule F Balance Sheet

Important: *Report all amounts in U.S. dollars computed in functional currency and translated into U.S. dollars in accordance with U.S. GAAP. See page XX of the instructions for an exception for foreign disregarded entities that use DASTM.*

	Assets		(a) Beginning of annual accounting period	(b) End of annual accounting period
1	Cash and other current assets	1		
2	Other assets	2		
3	Total assets	3		
	Liabilities and Owner's Equity			
4	Liabilities	4		
5	Owner's equity	5		
6	Total liabilities and owner's equity	6		

Schedule G Other Information

		Yes	No
1	During the tax year, did the foreign disregarded entity own an interest in any trust?		
2	During the tax year, did the foreign disregarded entity own at least a 10% interest, directly or indirectly, in any foreign partnership?		
3	Were substantially all of the assets of the foreign disregarded entity sold, exchanged, transferred, or otherwise disposed of during the tax year?		
4	*Answer the following question only if the foreign disregarded entity made its election to be treated as disregarded from its owner during the tax year:* Did the tax owner claim a loss with respect to stock or debt of the foreign disregarded entity as a result of the election?		
5	*Answer the following question only if the foreign disregarded entity is owned directly or indirectly by a domestic corporation and the foreign disregarded entity incurred a net operating loss for the tax year:* Is the foreign disregarded entity a separate unit as defined in Regulation section §1.1503-2(c)(3) and (4)? (If yes, see the instructions)		
6	*Answer the following question only if the tax owner of the foreign disregarded entity is a controlled foreign corporation (CFC):* Were there any intracompany transactions between the foreign disregarded entity and the CFC or any other branch of the CFC during the tax year, in which the foreign disregarded entity acted as a manufacturing, selling, or purchasing branch?		

Schedule H Current Earnings and Profits or Taxable Income (see page XX of the instructions)

Important: *Enter the amounts on lines 1 through 6 in functional currency.*

1	Current year net income or (loss) per foreign books of account	1	
2	Total net additions	2	
3	Total net subtractions	3	
4	Current earnings and profits (or taxable income—see instructions) (line 1 plus line 2 minus line 3)	4	
5	DASTM gain or loss (if applicable)	5	
6	Combine lines 4 and 5	6	
7	Current earnings and profits (or taxable income) in U.S. dollars (line 6 translated at the appropriate exchange rate as defined in section 989(b) and the related regulations (see instructions))	7	
	Enter exchange rate used for line 7 ▶		

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SCHEDULE M (Form 8858)
(December 2004)
Department of the Treasury
Internal Revenue Service

Transactions Between Foreign Disregarded Entity of a Foreign Tax Owner and the Filer or Other Related Entities

▶ Attach to Form 8858. ▶ See separate instructions.

OMB No. 1545-XXXX

Name of person filing Form 8858 | **Identifying number**

Name of foreign disregarded entity | Name of tax owner

Important: *Complete a **separate** Schedule M for each foreign disregarded entity for which the tax owner is a controlled foreign corporation or controlled foreign partnership. Enter the totals for each type of transaction that occurred during the annual accounting period between the foreign disregarded entity and the persons listed in the applicable columns (b) through (f). All amounts must be stated in U.S. dollars translated from functional currency at the appropriate exchange rate for the foreign disregarded entity's tax year (see page XX of the instructions).*

Enter the relevant functional currency and the exchange rate used throughout this schedule ▶

Check the box that identifies the status of the tax owner and complete lines 1 through 19 with respect to the applicable columns (b) through (f):

☐ **Controlled Foreign Partnership** **(a)** Transactions of foreign disregarded entity	**(b)** U.S. person filing this return	**(c)** Any domestic corporation or partnership controlling or controlled by the filer	**(d)** Any foreign corporation or partnership controlling or controlled by the filer (other than the tax owner)	**(e)** Any U.S. person with a 10% or more direct interest in the controlled foreign partnership (other than the filer)	
☐ **Controlled Foreign Corporation** **(a)** Transactions of foreign disregarded entity	**(b)** U.S. person filing this return	**(c)** Any domestic corporation or partnership controlled by the filer	**(d)** Any foreign corporation or partnership controlled by the filer (other than tax owner)	**(e)** 10% or more U.S. shareholder of any corporation controlling the tax owner	**(f)** 10% or more U.S. shareholder, or other owner, of any entity controlling the tax owner
1 Sales of inventory					
2 Sales of property rights					
3 Compensation received for certain services					
4 Commissions received					
5 Rents, royalties, and license fees received					
6 Dividends/Distributions received					
7 Interest received					
8 Other					
9 Add lines 1 through 8					
10 Purchases of inventory					
11 Purchases of tangible property other than inventory					
12 Purchases of property rights					
13 Compensation paid for certain services					
14 Commissions paid					
15 Rents, royalties, and license fees paid					
16 Interest paid					
17 Add lines 10 through 16					
18 Amounts borrowed (see page xx of the instructions)					
19 Amounts loaned (see page xx of the instructions)					

Part IV - Items of General Interest

Information Reporting With Respect to Foreign Disregarded Entities

Announcement 2004-4

The Internal Revenue Service (the "Service") and the Treasury Department (the "Treasury") announce that they are requesting comments from the public on proposed new Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities. The form will be required to be filed by U.S. persons that own a foreign disregarded entity (FDE) directly or, in certain circumstances, indirectly or constructively (for example, U.S. persons that own a 10 percent or greater interest in an FDE indirectly through a controlled foreign corporation (CFC) or controlled foreign partnership (CFP)). An FDE is an entity that is created or organized in a foreign jurisdiction and that is disregarded as separate from its owner for U.S. income tax purposes under section 301.7701-2 and -3 of the Income Tax Regulations. The reporting of information on Form 8858 will be required under the authority of sections 6011, 6012, 6031 and 6038 of the Internal Revenue Code and the related regulations, for annual accounting periods of tax owners of FDEs beginning on or after January 1, 2004. Attached to this announcement is a copy of the proposed form, with respect to which the Service and the Treasury are requesting comments from the public.

BACKGROUND

Proposed Form 8858 was developed to enable the Service to administer more efficiently the provisions of the tax law with respect to U.S. persons that own FDEs. The promulgation of the elective entity classification regulations in 1997 has facilitated the use of FDEs by U.S. persons with cross-border investments or operations. The Service has had significant difficulties administering the relevant provisions of the tax law because the information reporting requirements still date from a time when the substantive entity classification rules did not contemplate disregarded entities. The current lack of relevant information reporting with respect to FDEs has hindered the Service's ability to identify potential compliance issues efficiently and effectively. The Service is committed to reducing the length of the corporate examination process and improving the currency of examinations. The information to be reported on Form 8858 will help the Service identify

issues more efficiently, ensuring that the Service can better focus resources and reduce exam cycle time.

PROPOSED FORM 8858

Proposed Form 8858 is three pages long, and consists of one section and five schedules, plus a separate Schedule M. The introductory section of proposed Form 8858 requests identifying information. The schedules to proposed Form 8858 include requests for abbreviated income statement information (Schedule C), abbreviated balance sheet information (Schedule F), and summary information regarding taxable income or earnings and profits (Schedule H). Schedule C-1 requests information relating to the foreign currency rules applicable to foreign disregarded entities, and Schedule G consists of six specific yes/no questions. Schedule M requests information regarding related party transactions between an FDE owned by a CFP or a CFC and a related person other than the CFP or CFC. Information regarding transactions between an FDE and its tax owner or between or among FDEs of the same tax owner is not requested, except where such information is required to administer provisions of the tax law that recognize inter-branch transactions, such as the foreign currency rules.

To ensure that taxpayer burden is minimized, each item of information requested on proposed Form 8858 has been evaluated to make certain that it is necessary to the administration of the tax law and that it is not duplicative of information already required to be reported. Proposed Form 8858 requests only the minimum information needed to identify the tax items that are attributable to an FDE. Almost all of the items of information requested from U.S. persons on proposed Form 8858 with respect to an FDE are currently required to be reported by such U.S. persons on an aggregate basis on, for example, Form 5471 (in the case of FDEs of CFCs) or Form 8865 (in the case of FDEs of CFPs).

Consistent with the objectives of proposed Form 8858 and consistent with section 6038 of the Code, with a view to minimizing taxpayer burden and aiding Service efforts to reduce exam cycle time, the Service and the Treasury also intend to review Forms 5471 and 8865 to ensure that the information requested on these forms enables the Service to administer effectively the tax law applicable to U.S. owners of CFCs and CFPs, is necessary to the administration of the tax law, and is not duplicative of information required to be reported on proposed Form 8858 or other forms.

GENERAL QUESTIONS ABOUT FORM 8858

<u>Who will be required to file Form 8858?</u>

Form 8858 will be required to be filed by U.S. persons that are tax owners (as

defined below) of FDEs, or that own certain interests in foreign tax owners of FDEs.

Specifically, U.S. persons that are tax owners of FDEs would complete the entire Form 8858 except for Schedule M. In the case of U.S. persons that are required to file a Form 5471 with respect to a CFC that is a tax owner of an FDE, such U.S. persons that are Category 4 filers of Form 5471 would complete the entire Form 8858 and separate Schedule M. U.S. persons that are Category 5 filers of Form 5471 (i.e., noncontrolling shareholders) would complete only the identifying information on page 1 of Form 8858, and Schedules G and H. Schedule M would not be required from Category 5 filers of Form 5471.

In the case of U.S. persons that are required to file a Form 8865 with respect to a CFP that is a tax owner of an FDE, such U.S. persons that are Category 1 filers of Form 8865 would complete the entire Form 8858 and separate Schedule M. U.S. persons that are Category 2 filers of Form 8865 (i.e., noncontrolling partners) would complete only the identifying information on page 1 of Form 8858, and Schedules G and H. Schedule M would not be required from Category 2 filers of Form 8865.

Who is the tax owner of an FDE?

For purposes of completing the Form 8858, the tax owner of the FDE is the person that is treated as owning the assets and liabilities of the FDE for purposes of U.S. income tax law.

Who is the direct owner of an FDE?

For purposes of completing the Form 8858, the direct owner of an FDE is the legal owner of the disregarded entity.

For example, assume A, a U.S. individual, is a 60 percent partner of CFP, a controlled foreign partnership. FDE 1 is a foreign disregarded entity owned by CFP, and FDE 2 is a foreign disregarded entity owned by FDE 1. In this example, FDE 1 is the direct owner of FDE 2, and CFP is the direct owner of FDE 1. CFP is the tax owner with respect to both FDE 1 and FDE 2. A would be required to file the Forms 8858 relating to FDE 1 and FDE 2.

When will Form 8858 be required to be filed?

Form 8858 will be due when the filer's U.S. income tax or information return is due, including extensions.

How will Form 8858 be filed?

The filer will be required to file Form 8858 as an attachment to the filer's U.S. income tax or information return. In the case of a filer that is not the tax owner of the FDE, the filer will be required to attach Form 8858 to any form filed by the filer with respect to the foreign entity that is the tax owner of the FDE.

For example, where a U.S. person indirectly owns an FDE through a CFC, the CFC is the tax owner of the FDE. In this instance, the U.S. person will be required to file a Form 8858 because it indirectly owns the FDE through a CFC. The Form 8858 will be required to be filed as an attachment to the Form 5471 filed with the U.S. person's U.S. income tax return.

A separate Form 8858, including Schedule M if required to be filed, will be required for each FDE.

Will there be any exceptions to filing Form 8858?

Instructions for the Form 8858 will provide filing exceptions similar to those set forth in the instructions for Form 5471 and Form 8865. For example, exceptions from filing for multiple filers of the same information, for members of consolidated groups, and for owners of dormant FDEs will apply for purposes of Form 8858.

What is the effective date for Form 8858?

Form 8858 will be required to be filed for annual accounting periods of tax owners of FDEs beginning on or after January 1, 2004.

Can Form 8858 be filed electronically?

The instructions for filing Form 8858 will include information on electronic filing.

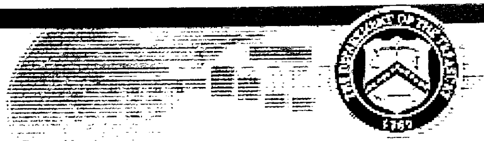
REQUEST FOR COMMENTS ON THE FORM

The Service and the Treasury are requesting comments about proposed Form 8858. The Service and the Treasury are particularly interested in receiving comments on matters that should be addressed in the instructions to Form 8858, such as whether clarification is needed as to specific aspects of the filing requirements or the information requested on the form. The Service and the Treasury also are requesting comments about current Forms 5471 and 8865, in particular whether any modifications are necessary in light of proposed Form 8858 to ensure that the information requested on Forms 5471 and

8865 is necessary to the administration of the tax law and is not duplicative of information required to be reported on proposed Form 8858 or other forms. Written comments should be sent to: Tax Products Coordinating Committee, Internal Revenue Service, SE:W:CAR:MP:T, Room 6406, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Alternatively, comments may be e-mailed to tfpmail@publish.no.irs.gov. Comments must be received by March 1, 2004.

The principal author of this announcement is Alexandra Helou of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury and the IRS participated in its development. For further information regarding this announcement contact Alexandra Helou at (202) 622-3840 (not a toll-free call).

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

December 23, 2003
js-1067

Treasury Announces Administrative Changes to the Terrorism Risk Insurance Program

The Treasury Department today reminded all participants and observers of the Terrorism Risk Insurance Program that there will be two important changes in the program's administration in 2004.

As mandated by Congress, beginning on January 1, 2004 and throughout the remainder of 2004, an insurer's deductible will increase from 7 percent to 10 percent of the insurer's direct earned premium over the previous calendar year. Second, the "mandatory availability" provisions of the Act will require insurers to continue to make available coverage for certified acts of terrorism for the full annual policy periods of all commercial property and casualty insurance policies that are issued or renewed in 2004. The "make available" requirement under the Act applies to December 31, 2004 while coverage issued as a result of the requirement will extend for the normal annual policy period beyond 2004. As required by the Act, the Treasury Department will be evaluating whether the "mandatory availability" provisions should be extended for policies that are issued or renewed in 2005.

The final and proposed regulation and other information related to the Terrorism Risk Insurance Program can be found at http://www.treasury.gov/trip/.

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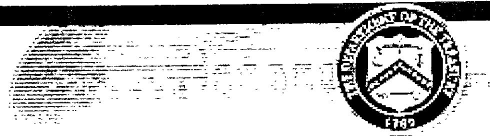
PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

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December 30, 2003
js-1068

Treasury and IRS Issue Final Regulations Defining Income Under Section 643

Today, the Treasury Department and the IRS issued final regulations amending the definition of income under section 643 of the Internal Revenue Code. These regulations also clarify the circumstances under which capital gains are included in the distributable net income (DNI) of an estate or trust.

"This new definition of income clarifies the application of federal tax law in light of recent state law changes," stated Pam Olson, the Treasury's Assistant Secretary for Tax Policy. "The regulations are an example of the appropriate evolution of federal tax law to reflect and facilitate non-tax changes in the law that apply to taxpayers."

Section 643(b) of the Code defines income for purposes of numerous federal tax provisions, including determining qualification for the estate and gift tax marital deduction, and computing required distributions from pooled income funds and certain charitable remainder trusts. With certain exceptions, this definition generally relies on the definition of trust accounting income under state law and the trust agreement or will. Many states have now changed their definitions of income to permit trusts and estates to adopt a more profitable method of investing their funds, and to promote more equitable and impartial treatment of those with interests in the income or principal of those entities.

The text of the final regulations is attached.

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Related Documents:

- The text of the final regulations

[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 20, 25, and 26

[TD 9102]

RIN 1545-AX96

Definition of Income for Trust Purposes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations revising the definition of income under section 643(b) of the Internal Revenue Code. The regulations are necessary to reflect changes in the definition of trust accounting income under state laws. The final regulations also clarify the situations in which capital gains are included in distributable net income under section 643(a)(3). Conforming amendments are made to regulations affecting ordinary trusts, pooled income funds, charitable remainder trusts, trusts that qualify for the gift and estate tax marital deduction, and trusts that are exempt from generation-skipping transfer taxes. The regulations affect the grantors, beneficiaries, and fiduciaries of trusts.

DATES: Effective Date: These regulations are effective January 2, 2004.

Applicability date: Generally, the final regulations are applicable to trusts and estates for taxable years ending after January 2, 2004. See revised §§1.642(c)-2, 1.642(c)-5, and 1.664-3 for special dates of applicability affecting those sections.

FOR FURTHER INFORMATION CONTACT: Bradford R. Poston at (202) 622-3060

(not a toll-free number).

Background

On February 15, 2001, proposed regulations (REG-106513-00) were published in the **Federal Register** [66 FR 10396] containing proposed amendments to the Income Tax Regulations [26 CFR part 1], the Estate Tax Regulations [26 CFR part 20], the Gift Tax Regulations [26 CFR part 25], and the Generation-Skipping Transfer Tax Regulations [26 CFR part 26] relating to the definition of income for trust purposes. A public hearing was held on the proposed regulations on June 8, 2001. Written comments were received on the proposed regulations. The proposed regulations, with certain changes in response to the comments, are adopted as final regulations.

Summary of Comments and Explanation of Revisions

Definition of Income

The proposed regulations provide that, for purposes of determining what constitutes trust accounting income under section 643(b), trust provisions that depart fundamentally from the traditional concepts of income and principal generally will continue to be disregarded as they have been under the existing regulations. One commentator suggested that, instead of using traditional concepts of income and principal, the benchmark should be whether there is a departure from the duty to administer the trust or estate impartially based upon what is fair and reasonable to all the parties. One commentator suggested eliminating the distinction between trust accounting income and principal. Another suggested that the regulations clarify the consequences of a fundamental departure from traditional concepts of income and

principal.

Income under section 643(b) is the amount of income determined under the terms of the governing instrument and applicable local law. This concept of income is used as the measure of the amount that must be distributed from a trust in order for the trust to qualify for certain treatment under various provisions of the Internal Revenue Code. Trusts classified as simple trusts, pooled income funds, net income charitable remainder unitrusts, and qualified subchapter S trusts (QSSTs) are required to make distributions measured at least in part by the amount of trust accounting income. A similar concept applies to trusts that qualify for the gift and estate tax marital deductions. Because section 643(b) requires a determination of trust accounting income, it is not possible to ignore any distinctions between trust accounting income and principal as suggested by a commentator.

A trust instrument may provide for any amount to be distributed to beneficiaries currently. Trust provisions that measure the amount of the distribution by reference to income but define income differently from the state statutory definition of income generally will be recognized for state law purposes. However, Internal Revenue Code provisions that require the current distribution of income to qualify the trust for certain federal tax treatment are based on the assumption that the income beneficiary will receive what is traditionally considered to be income. In some situations, such as with QSSTs and marital deduction trusts for spouses who are U.S. citizens, the income beneficiary is permitted to also receive principal distributions as long as all the income is currently distributed. In other situations, as with pooled income funds and net income charitable remainder unitrusts, only the income may be distributed. In all these

situations, the determination of income is critical. Thus, the definition of income under the terms of the governing instrument and applicable local law must not depart fundamentally from traditional concepts of income and principal, if the desired federal tax treatment is to be secured.

The IRS and the Treasury Department recognize that state statutes are in the process of changing traditional concepts of income and principal in response to investment strategies that seek total positive return on trust assets. These statutes are designed to ensure that, when a trust invests in assets that may generate little traditional income (including dividends, interest, and rents), the income and remainder beneficiaries are allocated reasonable amounts of the total return of the trust (including both traditional income and capital appreciation of trust assets) so that both classes of beneficiaries are treated impartially. Some statutes permit the trustee to pay to the person entitled to the income a unitrust amount based on a fixed percentage of the fair market value of the trust assets. Other statutes permit the trustee the discretion to make adjustments between income and principal to treat the beneficiaries impartially. Under the proposed regulations, a trust's definition of income in conformance with applicable state statutes will be respected for federal tax purposes when the state statutes provide for a reasonable apportionment of the total return of the trust.

Some commentators suggested that, even in those states that have not enacted legislation specifically authorizing powers to adjust or a unitrust definition of income, trust instruments containing such provisions should be respected as defining income for purposes of section 643(b). Under a unitrust or power to adjust, items traditionally allocable to principal (such as gains from the sale or exchange of trust assets) may,

under certain circumstances, be allocated to income, and items traditionally allocable to income (such as dividends, interest, and rents) may, under certain circumstances, be allocated to principal. The proposed regulations already recognize that gains from the sale or exchange of trust assets may, under certain circumstances, be allocated to income under the terms of the governing instrument. However, §1.643(b)-1 has always provided that the allocation to principal, under the terms of the governing instrument, of items that traditionally would be allocable to income will not be respected for purposes of section 643(b), and this position is maintained in the final regulations. Accordingly, the IRS and the Treasury Department believe that an allocation to principal of traditional income items should be respected for Federal tax purposes only if applicable state law has specifically authorized such an allocation in certain limited circumstances, such as when necessary to ensure impartiality regarding a trust investing for total return. Under the regulations, a state statute specifically authorizing certain unitrust payments in satisfaction of an income interest or certain powers to adjust would satisfy that requirement. Further, the IRS and the Treasury Department acknowledge that other actions may constitute applicable state law, such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under the laws of that state. However, a court order applicable only to the trust before the court would not constitute applicable state law for this purpose.

Two commentators suggested that the permissible range of unitrust percentages should include any percentage permitted by state statutes. The IRS and the Treasury Department believe that when establishing a unitrust percentage that attempts to yield the equivalent of income over a long period of time that may encompass wide variations

in economic conditions, a range of 3% to 5% will be considered a reasonable apportionment of a trust's total return. In response to one comment, the range of unitrust percentages has been adjusted in the final regulations to include, rather than exclude, unitrust percentages of 3% and 5%. Also in response to comments, the final regulations state that the periodic redetermination of the fair market value of the trust assets may be done as of a particular date each year or as an average determined on a multiple year basis.

The proposed regulations state that traditionally ordinary income is allocated to income and capital gains are allocated to principal. One commentator pointed out that ordinary income and capital gains are tax concepts and not concepts that have any meaning for purposes of trust accounting income. The final regulations have been revised to state that traditionally items such as dividends, interest, and rents are allocated to income and the proceeds from the sale or exchange of trust assets are allocated to principal.

The proposed regulations refer to a power to make equitable adjustments between income and principal and describe the circumstances under which these adjustments currently are permitted under state law and will be respected for Federal tax purposes. Specifically, state statutes permit adjustments when trust assets are invested under the state's prudent investor standard, the trust instrument refers to income in describing the amount that may or must be paid to a beneficiary, and the trustee, after applying the state statutory rules regarding the allocation of receipts and disbursements between income and principal, is unable to administer the trust impartially. One commentator requested clarification of the requirements a trustee

must satisfy to make an adjustment that will be respected for Federal tax purposes. Those requirements are a matter of local law and may differ from state to state; the trustee must meet whatever requirements are imposed by applicable local law on the exercise of this power. One commentator pointed out that state statutes do not include the term equitable in referring to this power and suggested deleting that term. One commentator suggested adding "generally" to the statement concerning the circumstances in which these adjustments are permitted because some states may permit these adjustments without enacting a prudent investor standard. These two suggestions are adopted in the final regulations.

One commentator suggested clarifying that the definition of income in the regulations also applies to spray and sprinkle trusts. The final regulations provide that allocations apportioning the total return of the trust pursuant to the state statute will be respected regardless of whether the trust has one or more income beneficiaries and irrespective of whether income must or may be paid out each year. The commentator also suggested that allocations pursuant to one apportionment method should be respected even if a different apportionment method was used in prior years. The final regulations provide that, as long as the trust complies with the requirements of state statutes for switching between methods authorized by the statute, then, when the trust switches between permitted methods: (i) the method used in any year will be respected for Federal tax purposes; (ii) the switch will not constitute a recognition event under section 1001; and (iii) neither the grantor nor any beneficiary will have any gift tax consequences. This provision does not apply to switches between methods not specifically authorized by state statute.

It has been questioned whether the changes to §1.643(b)-1 affect the amount of income required to be distributed by QSSTs. Section 1.1361-1(j) provides that QSSTs are required to distribute income as defined in §1.643(b)-1. Therefore, no amendment to the QSST regulations is necessary for the new provisions of §1.643(b)-1 to be applicable to QSSTs.

The proposed regulations provide that an allocation of capital gains to income will be respected if made either (i) pursuant to the terms of the governing instrument and applicable local law, or (ii) pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law, or by the governing instrument if not inconsistent with local law. One commentator suggested that in the phrase "pursuant to the terms of the governing instrument and applicable local law," the term "and" be replaced with "or." The phrase with the term "and" is consistent with the statutory language of section 643(b), and, therefore, no change has been made.

One commentator suggested that a discretionary power to allocate capital gains to income should not have to be exercised consistently. The exercise of the power generally affects the actual amount that may or must be distributed to the income beneficiaries and affects whether the trust or the beneficiary will be taxed on the capital gains. Thus, the IRS and the Treasury Department agree that the power does not have to be exercised consistently, as long as it is exercised reasonably and impartially. However, if the amount of income is determined by a unitrust amount, the exercise of this discretionary power has no effect on the amount of the distribution, but does affect whether the beneficiary or the trust is taxed on the capital gains. Under these circumstances, a discretionary power must be exercised consistently. One

commentator suggested changing the phrase "if not inconsistent with local law" because powers to allocate capital gains to income will almost always be inconsistent with the default provisions of state law. Accordingly, the phrase has been changed to "if not prohibited by local law."

Pooled Income Funds

Several commentators were concerned about the provision in the proposed regulations that long-term capital gain does not qualify for the income tax charitable deduction available to pooled income funds (PIFs), if the amount of income payable to the noncharitable beneficiaries may be either a unitrust amount or an amount that could include unrealized appreciation in the value of trust assets pursuant to the exercise of a trustee's power to adjust. One commentator suggested that, if income is defined as a unitrust amount or is subject to the trustee's power of adjustment, the provision in the proposed regulation invalidly limits the amount that can be paid to the noncharitable beneficiaries of the PIF.

This regulatory provision places no prohibition on paying to the noncharitable beneficiaries an amount of income determined under the governing instrument and applicable local law, even if that income is a unitrust amount or is determined pursuant to a power of adjustment that takes into account unrealized appreciation. Rather, this regulatory provision addresses whether long-term capital gains recognized during a year but not distributed during that year are permanently set aside for a charitable purpose as required by section 642(c)(3) to allow the PIF to claim a charitable deduction for these amounts. If income is defined as a unitrust amount, a future payment of income to the noncharitable beneficiaries may be attributable to long-term

capital gains realized, but not distributed, in the current year. If income is determined pursuant to a power of adjustment that takes into account unrealized appreciation, a portion of the capital gain recognized during a year may be attributable to appreciation that was the basis for a distribution to the noncharitable beneficiaries in a prior year. In both situations, the long-term capital gains are not permanently set aside for charitable purposes and therefore do not qualify for the charitable deduction in computing the PIF's income tax liability.

Some commentators were concerned that PIFs need to be able to distribute more than the traditional amounts of income to remain useful vehicles for charitable giving. They suggest that PIFs should be able to define trust accounting income as traditional income plus any realized capital gains for the year but the total amount defined as income cannot exceed a specified percentage. Thus, the annual payout would be the lesser of a unitrust amount or trust accounting income defined to include gains from the appreciation of assets sold by the trust during the year.

Distinct statutory provisions govern PIFs and charitable remainder unitrusts (CRUTs). The provisions applicable to each type of trust are specifically designed to achieve statutory objectives based on the nature of the charitable and noncharitable interests in each type of trust. The commentators' suggestion is, in effect, to permit PIFs to operate in the same manner as a net income CRUT, but without applying any of the other CRUT requirements to these funds. There is no authority for incorporating certain provisions applicable to CRUTs into the provisions applicable to PIFs.

Nevertheless, the power to adjust authorized by many state statutes currently applies to PIFs administered in those states. If permitted under the terms of the

governing instrument and state statutes, a trustee may use the power to make adjustments by allocating to income a portion of the sales proceeds from trust assets in order to treat the income and remainder beneficiaries impartially. The proper exercise of a power to adjust may provide the income beneficiaries with amounts in excess of the amount of traditional income. The final regulations provide that, for a PIF, the amount of proceeds from the sale of assets that may be allocated to income pursuant to a power to adjust is limited to the amount by which those proceeds exceed the fair market value of those assets as of the date those assets were contributed to or purchased by the PIF. This provision ensures that amounts attributable to the fair market value of assets on the date contributed to the PIF cannot be reallocated to income under a power to adjust. In addition, long-term capital gains from the sale or exchange of trust assets do not qualify for the charitable deduction under section 642(c)(3) to the extent that any sales proceeds are distributed to the income beneficiaries.

One commentator suggested that the "or" in the phrase "under the terms of the governing instrument or applicable local law" should be changed to "and" to be consistent with the statutory definition of income under section 643(b). This change has been made.

Charitable Remainder Trusts

Several commentators were concerned about the requirement in the proposed regulations that net income CRUTs under sections 664(d)(2) and 664(d)(3) contain their own definition of income if applicable state law provides that income is a unitrust amount. The purpose of this proposed requirement was to avert potential problems

with qualification of a net income CRUT in a state that defines income as a unitrust amount. Some commentators pointed out that state statutes provide alternative definitions of income and all that should be necessary is that the trust use a definition of income, whether contained in the terms of the governing instrument or applicable local law, that is not a unitrust amount. Therefore, the requirement that the trust contain its own definition of income has been eliminated from the final regulations.

Several commentators were concerned about the provision in the proposed regulations that the allocation of post-contribution capital gain to income, if permitted under the terms of the governing instrument and applicable local law, may not be discretionary with the trustee. Some suggested eliminating the prohibition on discretionary powers held by the trustee. Some suggested that a discretionary power should be permitted if held by an independent trustee. Some requested clarification that this prohibition does not apply to a trustee's power to allocate receipts to income or principal pursuant to state law.

The provision in the proposed regulations has no effect on the determination of trust accounting income under applicable state law that grants the trustee a power to reasonably apportion the total return of the trust. The provision is directed at discretion given the trustee under the terms of the governing instrument to allocate capital gains to income in some years and not others. Allowing the trustee this type of discretion is inconsistent with the requirements for net income CRUTs as explained in the legislative history. The settlor has the option of providing in the trust that the trustee is to distribute the lesser of the stated percentage payout or trust income. However, this option must be adopted in the trust instrument and not left to the discretion of the

trustee. See H.R. Conf. Rep. No. 91-782, at 296 (1969), reprinted in 1969-3 C.B. 644, 655. A power to allocate capital gains to income in some years and not others in the trustee's sole discretion is similar to having the discretionary ability to pay out either the trust income or the stated percentage payout each year, regardless of their relative values. Thus, the final regulations continue to provide that, for CRUTs, post-contribution capital gains may be included in the definition of income under the terms of the governing instrument or applicable local law, but not pursuant to a trustee's discretionary power granted by the trust instrument, rather than by state statute, to allocate capital gains to income.

Capital Gains and Distributable Net Income

Section 643(a)(3) provides that gains from the sale or exchange of capital assets generally are excluded from distributable net income (DNI) to the extent that these gains are allocated to corpus. However, capital gains allocated to corpus are included in DNI if they are either paid, credited, or required to be distributed, to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. In certain situations it is easily ascertained whether capital gains are paid to a beneficiary. For example, if the trust instrument provides that the proceeds from the sale of a certain asset are to be paid to a beneficiary upon sale, then any capital gain recognized upon the sale of that asset is paid to the beneficiary and is includible in DNI. However, the circumstances in which recognized capital gain determines the amount to be distributed to a beneficiary during the year are relatively rare.

More frequently, the trustee is authorized by the trust instrument to make discretionary distributions of principal or, by the recently-enacted state statutes, to pay

the income beneficiary a unitrust amount. In these circumstances, the amount of realized capital gain during the year does not affect the amount distributed to a beneficiary, and because money is fungible, it is difficult to ascertain whether capital gains are actually paid to the beneficiary. With respect to these situations, the proposed regulations attempt to clarify the circumstances in which capital gains are treated as distributed to a beneficiary and therefore are includable in DNI. The proposed regulations provide that capital gains will be treated as part of a distribution to a beneficiary, if the trustee allocates capital gains to the distribution pursuant to a discretionary power granted by local law or by the governing instrument (if not inconsistent with local law) to treat capital gains in this manner, provided the allocation power is exercised in a reasonable and consistent manner, and is evidenced on the trust's books, records, and tax returns.

Commentators requested guidance on several issues concerning the treatment of capital gains as part of a distribution to a beneficiary. These issues include clarification that one trustee may exercise the discretion differently for different trusts and that the treatment of capital gains from the sale of different types of assets may be different. Examples have been added to the final regulations to address these situations. In addition, some commentators were concerned about how a trustee may show consistency in the first year, whether the treatment in future years may be changed based on something other than a change in the definition of income, and whether existing trusts may establish a different treatment based on the rules in the final regulations.

In some respects, the proposed regulations merely clarify how a trustee may

demonstrate that capital gain has been paid to a beneficiary and therefore is includible in DNI under section 643(a)(3). This determination is relevant when distributions are made to beneficiaries that exceed the amount of DNI determined without regard to the capital gains. In the past this situation arose when mandatory or discretionary payments of principal were made. Because of the changes to the definition of income under state statutes, the number and variety of situations in which this determination is relevant are increasing. In implementing a different method for determining income under a state statute, the trustee may establish a pattern for including or not including capital gains in DNI to the extent that the amount of income so determined is greater than the amount of DNI determined without regard to the capital gains. This choice may be made irrespective of the trustee's practice under a prior legal definition of income regarding the treatment of capital gains as part of DNI when discretionary or mandatory distributions of principal were made from the trust.

Two commentators requested examples of the inclusion of capital gains in DNI when the trustee exercises a power to adjust between income and principal under applicable local law. The circumstances in which a power to adjust is exercisable may vary among states and may be determined by the powers of the trustee to make distributions of income and principal under the terms of the governing instrument. For example, if a trust instrument does not permit the trustee to distribute any corpus and the power to adjust under local law may be exercised only with respect to receipts from the sale of trust assets, the amount allocated to income under the power to adjust may have to be from the realized appreciation in the value of the assets that were sold. On the other hand, if the trust instrument permits discretionary distributions of principal and

the power to adjust under local law may be exercised only with respect to appreciation in the value of trust assets, the power to adjust may be similar to a unitrust amount that is payable irrespective of whether appreciated assets are sold during the year. Because of the potential variations in the circumstances and ramifications of exercising a power to adjust under applicable state statutes, additional examples would be unlikely to provide meaningful or complete guidance; thus, the final regulations contain no additional examples concerning inclusion of capital gains in DNI when the trustee exercises a power to adjust.

It has been pointed out that Examples 6 through 8 in §1.643(a)-3(e) of the proposed regulations, which are essentially identical to examples in the existing regulations, may no longer be consistent with the rules in the proposed regulations. In the final regulations, the corresponding examples, now Examples 7 through 10, have been updated to take into account the new rules. One commentator requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project.

Trusts Qualifying for Gift and Estate Tax Marital Deductions

The proposed regulations provide that a spouse will be treated as entitled to receive all net income from a trust, as required for the trust to qualify for the gift and estate tax marital deductions under §20.2056(b)-5(a)(1) of the Estate Tax Regulations and §25.2523(e)-1(f)(1) of the Gift Tax Regulations, if the trust is administered under applicable state law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the

requirements of §1.643(b)-1. Thus, a spouse who, as the income beneficiary, is entitled in accordance with the state statute and the governing instrument to a unitrust amount of no less than 3% and no more than 5% would be entitled to all the income from the trust for purposes of qualifying the trust for the marital deduction.

Several commentators suggested that a trust that provides for a unitrust payment to the spouse should satisfy the income standard even in states that have not enacted legislation defining income as a unitrust amount or providing that a right to income may be satisfied by such a payment. The income distribution requirement that must be satisfied for a trust to qualify for the gift and estate tax marital deductions ensures that the spouse receives what is traditionally considered to be income from the assets held in trust. As previously discussed, the IRS and the Treasury Department believe that only if applicable state law has authorized a departure from traditional concepts of income and principal should such a departure be respected for Federal tax purposes. A state statute specifically authorizing certain unitrust amounts in satisfaction of an income interest or certain powers to adjust in conformance with the provisions of §1.643(b)-1 would meet this standard. However, in the absence of a state statute, or, for example, a decision of the highest court of the state applicable to all trusts administered under that state's law, the applicable state law requirement will not be satisfied.

It has also been suggested that, in some circumstances, the proposed regulations would allow the spouse to receive less than all the traditional trust income, and therefore would conflict with the section 2056 statutory requirement that the spouse receive all trust income. For example, a spouse who, in accordance with the state

statute, receives a 4% unitrust amount would receive less than all the traditional income generated by the trust, if the trust's total dividends, interest, rents, etc. for the year exceed 4%. However, that spouse would receive more than the amount of traditional income earned by the trust in any year that the trust's total dividends, interest, rents, etc. do not exceed 4%. The regulations are intended to strike a reasonable balance between the marital deduction statutory requirements and the many state statutes intended to facilitate the investment of trust assets while ensuring equitable treatment for the income and remainder beneficiaries. Indeed, Congress contemplated that, in appropriate circumstances, an annuity could be treated as satisfying the statutory income distribution requirement. The flush language following section 2056(b)(7)(B)(ii) specifically authorizes regulations that treat an annuity "in a manner similar to an income interest in property." The IRS and Treasury Department believe that these regulations implement this statutory authorization in a reasonable manner by recognizing allocations under state statutes that provide for a reasonable apportionment of the total return of the trust.

Trusts Exempt From Generation-Skipping Transfer Tax

The proposed regulations expand the rules concerning changes that may be made to trusts that are exempt from the generation-skipping transfer tax because they were irrevocable on September 25, 1985, without causing the loss of the trusts' exempt status. If such an exempt trust is administered in conformance with applicable state law that permits a unitrust amount to be paid to the income beneficiary or permits adjustments between income and principal to ensure impartiality, and that meets the requirements of §1.643(b)-1, its exempt status will not be affected.

One commentator requested that the final regulations also provide that administration of an exempt trust as described in these regulations will not cause any trust beneficiary to be treated as making a gift and will not result in any taxable exchange by the trust or any of its beneficiaries. Another commentator requested that the final regulations clarify that changing the situs of a trust from a state with only a traditional definition of income to a state that permits unitrusts or powers to adjust will not affect the exempt status of the trust. Examples 11 and 12 have been revised to address these and similar concerns. The same conclusions apply to a change of situs in the opposite direction, from a state that permits unitrusts or the power to adjust to a state that has only the traditional definition of income.

Effective Dates

The proposed regulations provide that the final regulations apply for taxable years that begin on or after January 2, 2004. Commentators suggested that, as a number of states have already enacted statutes permitting the trustee to pay to the person entitled to the income a unitrust amount based on a fixed percentage of the fair market value of the trust assets or providing the trustee the discretion to make adjustments between income and principal to treat the beneficiaries impartially, the effective date provision should be changed to allow trustees to take advantage of these statutes for periods beginning before the date of the publication of the final regulations. As an alternative, one commentator suggested that the IRS issue guidance allowing trustees to rely on the proposed regulations prior to the publication of the final regulations.

The final regulations, in general, will become effective for taxable years of trusts

and estates ending after January 2, 2004. In addition, taxpayers may rely on the provisions of the final regulations for any taxable years in which a trust or estate is governed by a state statute authorizing a unitrust payment in satisfaction of the income interest of the income beneficiaries or granting the trustee a power to adjust between income and principal, in each case as described in the final regulations.

With respect to CRUTs, the prohibition of a trustee's discretionary power, granted solely by the governing instrument and not by applicable state statute, to allocate to income sales proceeds attributable to appreciation in the value of the asset after the date it was contributed to the trust or purchased by the trust is applicable to trusts created after January 2, 2004.

With respect to PIFs, the provision concerning the failure of net long-term capital gain to qualify for the charitable deduction if the income beneficiaries, under the terms of the governing instrument and the state statute, may receive a unitrust amount or an amount based on unrealized appreciation in the value of the fund's assets is applicable to taxable years of PIFs beginning after January 2, 2004. However, provided income has not already been determined in such a manner, the fund's governing instrument may be amended or reformed to eliminate this possibility. A judicial proceeding to reform the fund's governing instrument must be commenced, or a nonjudicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.

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, 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 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 authors of these regulations are Bradford R. Poston and Mary Berman of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 20

Estate taxes, Reporting and recordkeeping requirements.

26 CFR Part 25

Gift taxes, Reporting and recordkeeping requirements.

26 CFR Part 26

Generation-skipping transfer taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 20, 25, and 26 are 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 1.642(c)-2 is amended as follows:

1. Paragraph (c) is amended by adding two sentences after the first sentence.

2. Paragraph (e) is added immediately following paragraph (d).

The additions read as follows:

§1.642(c)-2 Unlimited deduction for amounts permanently set aside for a charitable purpose.

* * * * *

(c) * * * No amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if, under the terms of the fund's governing instrument and applicable local law, the trustee has the power, whether or not exercised, to satisfy the income beneficiaries' right to income by the payment of either: an amount equal to a fixed percentage of the fair market value of the fund's assets (whether determined annually or averaged on a multiple year basis); or any amount that takes into account unrealized appreciation in the value of the fund's assets. In addition, no amount of net long-term capital gain shall be considered permanently set aside for charitable

purposes to the extent the trustee distributes proceeds from the sale or exchange of the fund's assets as income within the meaning of §1.642(c)-5(a)(5)(i). * * *

* * * * *

(e) Effective dates. Generally, the second sentence of paragraph (c) of this section, concerning the loss of any charitable deduction for long-term capital gains if the fund's income may be determined by a fixed percentage of the fair market value of the fund's assets or by any amount that takes into account unrealized appreciation in the value of the fund's assets, applies for taxable years beginning after January 2, 2004. In a state whose statute permits income to be determined by reference to a fixed percentage of, or the unrealized appreciation in, the value of the fund's assets, net long-term capital gain of a pooled income fund may be considered to be permanently set aside for charitable purposes if the fund's governing instrument is amended or reformed to eliminate the possibility of determining income in such a manner and if income has not been determined in this manner. For this purpose, a judicial proceeding to reform the fund's governing instrument must be commenced, or a nonjudicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.

* * * * *

Par. 3. In §1.642(c)-5, paragraph (a)(5)(i) is revised to read as follows:

§1.642(c)-5 Definition of pooled income fund.

(a) * * *

(5) * * *

(i) The term income has the same meaning as it does under section 643(b) and the regulations thereunder, except that income generally may not include any long-term capital gains. However, in conformance with the applicable state statute, income may be defined as or satisfied by a unitrust amount, or pursuant to a trustee's power to adjust between income and principal to fulfill the trustee's duty of impartiality, if the state statute both provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)-1. In exercising a power to adjust, the trustee must allocate to principal, not to income, the proceeds from the sale or exchange of any assets contributed to the fund by any donor or purchased by the fund at least to the extent of the fair market value of those assets on the date of their contribution to the fund or of the purchase price of those assets purchased by the fund. This definition of income applies for taxable years beginning after January 2, 2004.

* * * * *

Par. 4. Section 1.643(a)-3 is revised to read as follows:

§1.643(a)-3 Capital gains and losses.

(a) In general. Except as provided in §1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they

are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) --

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph §1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

(c) Charitable contributions included in distributable net income. If capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(d) Capital losses. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See §1.642(h)-1 with respect to capital loss carryovers in the year of final

termination of an estate or trust.

(e) Examples. The following examples illustrate the rules of this section:

Example 1. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 2. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example 3. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

Example 4. The facts are the same as in Example 1, except that pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 5. The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 6. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Example 7. Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, all capital gains realized in the year of termination are included in distributable net income. See §1.641(b)-3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

Example 8. The facts are the same as Example 7, except Trustee is directed to pay B $10,000 before distributing the remainder of Trust assets to A. Because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1), none of Trust's distributable net income that includes all of the capital gains realized during the year of termination is allocated to B's distribution.

Example 9. The facts are the same as Example 7, except Trustee is directed to distribute one-half of the principal to A when A reaches 35 and the balance to A when A reaches 45. Trust assets consist entirely of stock in corporation M with a fair market value of $1,000,000 and an adjusted basis of $300,000. When A reaches 35, Trustee sells one-half of the stock and distributes the sales proceeds to A. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to A and therefore all the capital gain is included in distributable net income.

Example 10. The facts are the same as Example 9, except when A reaches 35, Trustee sells all the stock and distributes one-half of the sales proceeds to A. If authorized by the governing instrument and applicable state statute, Trustee may determine to what extent the capital gain is distributed to A. The $500,000 distribution to A may be treated as including a minimum of $200,000 of capital gain (and all of the principal amount of $300,000) and a maximum of $500,000 of the capital gain (with no principal). Trustee evidences the treatment by including the appropriate amount of capital gain in distributable net income on Trust's federal income tax return. If Trustee is not authorized by the governing instrument and applicable state statutes to determine to what extent the capital gain is distributed to A, one-half of the capital gain attributable to the sale is included in distributable net income.

Example 11. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full

satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example 12. The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example 13. The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

Example 14. Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. With respect to some trusts, Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by not including any capital gains in distributable net income on the Federal income tax returns for those trusts. With respect to other trusts, Trustee

intends to follow a regular practice of treating any net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by including net capital gains in distributable net income on the Federal income tax returns filed for these trusts. Trustee's decision with respect to each trust is a reasonable exercise of Trustee's discretion and, in future years, Trustee must treat the capital gains realized by each trust consistently with the treatment by that trust in prior years.

(f) Effective date. This section applies for taxable years of trusts and estates ending after January 2, 2004.

Par. 5. Section 1.643(b)-1 is revised to read as follows:

§1.643(b)-1 Definition of income.

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a

reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically

authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances. In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law. This section is effective for taxable years of trusts and estates ending after January 2, 2004.

Par. 6. In §1.651(a)-2, paragraph (d) is added to read as follows:

§1.651(a)-2 Income required to be distributed currently.

* * * * *

(d) If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income. This paragraph (d) applies for taxable years of trusts ending after January 2, 2004.

Par. 7. In §1.661(a)-2, paragraph (f) is revised to read as follows:

§1.661(a)-2 Deduction for distributions to beneficiaries.

* * * * *

(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e). This paragraph applies for taxable years of trusts and estates ending January 2, 2004.

Par. 8. Section 1.664-3 is amended as follows:

1. Paragraphs (a)(1)(i)(b)(3) and (4) are revised.

2. Paragraph (a)(1)(i)(b)(5) is removed.

The revisions read as follows:

§1.664-3 Charitable remainder unitrust.

(a) * * *

(1) * * *(i) * * *

(b) * * *

(3) For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust.

Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

(4) The rules in paragraph (a)(1)(i)(b)(1) and (2) of this section are applicable for taxable years ending after April 18, 1997. The rule in the first sentence of paragraph (a)(1)(i)(b)(3) is applicable for taxable years ending after April 18, 1997. The rules in the second, fourth, and fifth sentences of paragraph (a)(1)(i)(b)(3) are applicable for taxable years ending after January 2, 2004. The rule in the third sentence of paragraph (a)(1)(i)(b)(3) is applicable for sales or exchanges that occur after April 18, 1997. The rule in the sixth sentence of paragraph (a)(1)(i)(b)(3) is applicable for trusts created after January 2, 2004.

* * * * *

PART 20--ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 9. The authority citation for part 20 continues to read in part as follows:

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

Par. 10. Section 20.2056(b)-5 is amended by adding a new sentence to the end

of paragraph (f)(1) to read as follows:

§20.2056(b)-5 Marital deduction; life estate with power of appointment in surviving spouse.

* * * * *

(f) * * * (1) * * * In addition, the surviving spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)-1 of this chapter.

* * * * *

Par. 11. Section 20.2056(b)-7 is amended by adding a new sentence to the end of paragraph (d)(1) to read as follows:

§20.2056(b)-7 Election with respect to life estate for surviving spouse.

* * * * *

(d) * * * (1) * * * A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

* * * * *

Par. 12. Section 20.2056(b)-10 is amended by adding a new sentence at the end of the section to read as follows:

§20.2056(b)-10 Effective dates.

* * * In addition, the rule in the last sentence of §20.2056(b)-5(f)(1) and the rule in the last sentence of §20.2056(b)-7(d)(1) regarding the effect on the spouse's right to income if applicable local law provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of the trust are applicable with respect to trusts for taxable years ending after January 2, 2004.

Par. 13. Section 20.2056A-5 is amended by adding a new sentence in paragraph (c)(2) after the third sentence to read as follows:

§20.2056A-5 Imposition of section 2056A estate tax.

* * * * *

(c) * * *

(2) * * * However, distributions made to the surviving spouse as the income beneficiary in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount), or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will be considered distributions of trust income if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)-1 of this chapter. * * *

* * * * *

Par. 14. Section 20.2056A-13 is revised to read as follows:

§20.2056A-13 Effective dates.

Except as provided in this section, the provisions of §§20.2056A-1 through 20.2056A-12 are applicable with respect to estates of decedents dying after August 22, 1995. The rule in the fourth sentence of §20.2056A-5(c)(2) regarding unitrusts and distributions of income to the surviving spouse in conformance with applicable local law is applicable to trusts for taxable years ending after January 2, 2004.

PART 25--GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 15. The authority citation for part 25 continues to read in part as follows:

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

Par. 16. Section 25.2523(e)-1 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

§25.2523(e)-1 Marital deduction; life estate with power of appointment in donee spouse.

* * * * *

(f) * * * (1) * * * In addition, the spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section if the spouse is entitled to income as defined or determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)-1 of this chapter.

* * * * *

Par. 17. Section 25.2523(h)-2 is amended by adding a new sentence to the end of the section to read as follows:

§25.2523(h)-2 Effective dates.

* * * In addition, the rule in the last sentence of §25.2523(e)-1(f)(1) regarding the determination of income under applicable local law applies to trusts for taxable years

ending after January 2, 2004.

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

Par. 18. The authority citation for part 26 continues to read in part as follows:

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

Par. 19. Section 26.2601-1 is amended as follows:

1. The second and third sentences of paragraph (b)(4)(i) are revised to read as follows.

2. Paragraph (b)(4)(i)(D)(2) is amended by adding a new sentence to the end of the paragraph.

3. Paragraph (b)(4)(i)(E) is amended by adding Examples 11 and 12.

4. Paragraph (b)(4)(ii) is revised to read as follows.

The additions and revisions read as follows:

§26.2601-1 Effective dates.

* * * * *

(b) * * *

(4) * * *(i) * * * In general, unless specifically provided otherwise, the rules contained in this paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Thus (unless specifically noted), the rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of gain for purposes of section 1001.

* * * * *

(D) * * *

(2) * * * In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)-1 of this chapter.

(E) * * *

Example 11. Conversion of income interest to unitrust interest under state statute. In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

Example 12. Equitable adjustments under state statute. The facts are the same as in Example 11, except that in 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.

(ii) Effective dates. The rules in this paragraph (b)(4) are generally applicable on and after December 20, 2000. However, the rule in the last sentence of paragraph (b)(4)(i)(D)(2) of this section and Example 11 and Example 12 in paragraph (b)(4)(i)(E) of this section regarding the administration of a trust and the determination of income in conformance with applicable state law applies to trusts for taxable years ending after January 2, 2004.

* * * * *

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: December 16, 2003.

Pamela F. Olson,

Assistant Secretary of the Treasury.

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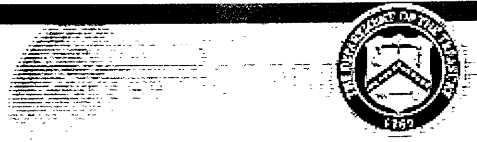

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 30, 2003
js-1069

Treasury Issues Depreciation Guidance

Today, the Treasury Department issued proposed, temporary, and final regulations to clarify which changes in depreciation are changes in method of accounting. These regulations and a revenue procedure also issued today will provide certainty for taxpayers and reduce controversy.

In recent years, uncertainty has existed regarding whether a change in the period of recovery of depreciable property was a change in method of accounting. The regulations provide that a change in the period of recovery specifically assigned by the Code, the regulations, or other published guidance is a change in method of accounting. The regulations also provide, however, that a change in the useful life of depreciable property is not a change in method of accounting if the useful life of the property is not specifically assigned by the Code, the regulations, or other published guidance. In addition, the regulations provide that a change in depreciation method or convention is a change in method of accounting.

Previously, the IRS issued guidance to permit a taxpayer who had claimed less than the depreciation allowable for its property to change its method of determining depreciation for the property. This guidance has enabled many taxpayers who had claimed less than the depreciation allowable to claim the full depreciation allowable. Today, the IRS and Treasury Department issued a revenue procedure to permit a taxpayer to make this change after the disposition of the depreciable property. As a result, a taxpayer who has claimed less than the depreciation allowable for its property will no longer risk permanently losing an allowable depreciation deduction.

The texts of the proposed, temporary, final regulations and the revenue procedure are attached. They will be published in the Federal Register in the next few days and are subject to minor technical changes.

-30-

Related Documents:

- notice of proposed rule making
- final and temporary regulations
- revenue procedure

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-126459-03]

RIN 1545-BC18

Changes in Computing Depreciation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing temporary regulations under sections 446(e) and 1016(a)(2) of the Internal Revenue Code relating to a change in computing depreciation or amortization as well as a change from a nondepreciable or nonamortizable asset to a depreciable or amortizable asset (or vice versa). The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 1, 2004. Outlines of topics to be discussed at the public hearing scheduled for April 7, 2004, at 10 a.m. must be received by March 17, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-126459-03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC, 20044. Alternatively, 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-126459-03), Courier=s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC or sent electronically, via the IRS Internet site at: http://www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sara Logan or Douglas Kim, (202) 622-3110; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622-4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** amend 26 CFR part 1 relating to sections 167, 446, and 1016 of the Internal Revenue Code (Code). The temporary regulations provide guidance under section 446(e) on whether a change in computing depreciation or amortization as well as a change from a nondepreciable or nonamortizable asset to a depreciable or amortizable asset (or vice versa) is a change in method of accounting that requires the consent of the Commissioner.

The text of those temporary 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 rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory

assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and 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 can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 7, 2004, beginning at 10:00 a.m. in the Auditorium, 7th Floor, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the

FOR FURTHER INFORMATION CONTACT section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 17, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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 reads as follows:

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

Par. 2. Section 1.167(e)-1 is amended by revising paragraphs (a) and (e) to read as follows:

§1.167(e)-1 Change in method.

(a) [The text of the proposed amendment to §1.167(e)-1(a) is the same as the text of ' 1.167(e)-1T(a) published elsewhere in this issue of the **Federal Register**].

* * * * *

(e) Effective date. This section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.167(e)-1 in effect prior to December 30, 2003 (§1.167(e)-1 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

Par. 3. Section 1.446-1 is amended by revising paragraphs (e)(2)(ii)(a), (e)(2)(ii)(b), (e)(2)(ii)(d), (e)(2)(iii), and (e)(4) to read as follows:

' 1.446-1 General rule for methods of accounting.

* * * * *

(e) * * *

(2) * * *

(ii)(a) and (b) [The text of the proposed amendment to §1.446-1(e)(2)(ii)(a) and (b) is the same as the text of ' 1.446-1T(e)(2)(ii)(a) and (b) published elsewhere in this issue of the **Federal Register**].

* * * * *

(d) [The text of this paragraph (e)(2)(ii)(d) is the same as the text of §1.446-1T(e)(2)(ii)(d) published elsewhere in this issue of the **Federal Register**].

(iii) [The text of the proposed amendment to §1.446-1(e)(2)(iii) is the same as the text of §1.446-1T(e)(2)(iii) published elsewhere in this issue of the **Federal Register**].

* * * * *

(4) Effective date--(i) In general. Except as provided in paragraphs (e)(3)(iii) and (e)(4)(ii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.446-1(e) in effect prior to December 30, 2003 (§1.446-1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) Changes involving depreciable or amortizable assets. With respect to paragraph (e)(2)(ii)(d) of this section, paragraph (e)(2)(iii) Examples 9 through 17 of this section, the addition of the language "certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section)" to the last sentence of paragraph (e)(2)(ii)(a) of this section, and the removal of all language regarding useful life and the sentence "On the other hand, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting" from paragraph (e)(2)(ii)(b) of this section--

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made for taxable years ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made for taxable years ending on or after December 30, 2003.

Par. 4. Section 1.1016-3 is amended by revising paragraphs (h) and (j) to read as follows:

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

* * * * *

(h) [The text of the proposed amendment to §1.1016-3(h) is the same as the text of §1.1016-3T(h) published elsewhere in this issue of the **Federal Register**].

* * * * *

(j) Effective date--(1) In general. Except as provided in paragraph (j)(2) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.1016-3 in effect prior to December 30, 2003 (§1.1016-3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(2) Depreciation or amortization changes. Paragraph (h) of this section applies to a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or former section 168 for taxable years ending on or

after December 30, 2003.

Deputy Commissioner for Services and Enforcement.
Mark E. Matthews

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9105]

RIN: 1545-BC17

Changes in Computing Depreciation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to a change in computing depreciation or amortization as well as a change from a nondepreciable or nonamortizable asset to a depreciable or amortizable asset (or vice versa). Specifically, these regulations provide guidance to any taxpayer that makes a change in depreciation or amortization on whether such change is a change in method of accounting under section 446(e) of the Internal Revenue Code and on the application of section 1016(a)(2) in determining whether the change is a change in method of accounting. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Dates: These regulations are effective January 2, 2004.

Applicability Dates: For dates of applicability, see §§1.167(e)-1T(e), 1.446(e)-1T(e)(4), and 1.1016-3T(j).

FOR FURTHER INFORMATION CONTACT: Sara Logan or Douglas Kim, (202) 622-3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 to provide regulations under sections 167, 446(e), and 1016(a)(2) of the Internal Revenue Code (Code). These regulations provide the changes in depreciation or amortization that are, and are not, a change in method of accounting under §1.446-1(e). Additionally, these regulations amend §1.167(e)-1 to provide that certain changes in depreciation method for property for which depreciation is determined only under section 167 are made without the consent of the Commissioner of Internal Revenue, and amend §1.1016-3 to provide that section 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting.

Explanation of Provisions

Background

Section 446 provides in general that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes the taxpayer's income in keeping the taxpayer's books. Section 446(e) provides that, except as otherwise expressly provided in chapter 1 of the Code, a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes the taxpayer's income in keeping the taxpayer's books shall, before computing the taxpayer's taxable

income under the new method, secure the consent of the Secretary.

Section 1.446-1(e)(2)(ii)(a) provides in pertinent part that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. However, ' 1.446-1(e)(2)(ii)(b) provides in pertinent part that a change in method of accounting does not include an adjustment in the useful life of a depreciable asset. Although such adjustment may involve the question of the proper time for the taking of a deduction, such item is traditionally corrected by adjustments in the current and future years.

Section 1.167(e)-1(a) provides that in general, any change in the method of computing the depreciation allowances with respect to a particular account (other than a change in method permitted or required by reason of the operation of former section 167(j)(2) and §1.167(j)-3(c)) is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that certain changes to the straight line method of depreciation will be permitted without consent as provided in former section 167(e)(1), (2), and (3). Any request for a change in method of depreciation shall be made in accordance with section 446 and the regulations under section 446.

In 1996, the IRS issued Rev. Proc. 96-31 (1996-1 C.B. 714), providing that a change from not claiming the depreciation or amortization allowable to claiming the depreciation or amortization allowable is a change in method of accounting for which the consent of the Commissioner of Internal Revenue is required.

In Kurzet v. Commissioner, 222 F.2d 830, 842-845 (10th Cir. 2000), the taxpayer sought to change the classification of property under section 168 from nonresidential real property to 15-year property thereby resulting in a change in recovery period from 31.5 years to 15 years. The Tenth Circuit held that a change in recovery period under section 168 is a change in method of accounting under section 446(e). In reaching its holding, the Tenth Circuit considered the taxpayer's argument that a change in recovery period is analogous to a change in useful life, but concluded that the Commissioner's interpretation of §1.446-1(e)(2)(ii) in Rev. Proc. 96-31 as requiring a taxpayer to obtain permission for a change in recovery period is not plainly erroneous or inconsistent with ' 1.446-1(e)(2)(ii).

In Brookshire Brothers Holding, Inc. & Subsidiaries v. Commissioner, 320 F.3d 507 (5th Cir. 2003), aff'g. T.C. Memo. 2001-150, reh'g en banc denied, 65 Fed. Appx. 511 (5th Cir. 2003), the Fifth Circuit held that a change in classification of property under section 168 is not a change in method of accounting under section 446(e) because the change is the functional equivalent of a change in useful life thereby resulting in the change falling under the useful life exception in §1.446-1(e)(2)(ii)(b). The Eighth Circuit in O'Shaughnessy v. Commissioner, 332 F.3d 1125 (8th Cir. 2003), rev'g in part 2002-1 U.S.T.C. (CCH) ¶50,235 (D. Minn. 2001), adopted the analysis in Brookshire and held that a change in classification of property under section 168 falls within the useful life exception and, thus, does not constitute a change in method of accounting under section 446(e).

Further, in Green Forest Manufacturing Inc. v. Commissioner, T.C.Memo. 2003-75, the Tax Court extended its reasoning in Brookshire. The court held that a change in computing depreciation from the general depreciation system in section 168(a) to the

alternative depreciation system in section 168(g) is a change in classification that falls within the useful life exception and, therefore, is not a change in method of accounting.

As a result of these decisions, there is inconsistent treatment of taxpayers with respect to whether a change in computing depreciation under section 168 is a change in method of accounting under section 446(e). These regulations clarify the changes in depreciation or amortization (depreciation) that are (and are not) changes in method of accounting under section 446(e).

Scope

The regulations provide the changes in depreciation for property for which depreciation is determined under section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or former section 168, of the Code that are (and are not) changes in method of accounting under section 446(e). The regulations also clarify that the rules in §1.167(e)-1 with respect to a change in the depreciation method made without the consent of the Commissioner apply only to property for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168).

Changes in Depreciation that are Changes in Method of Accounting

In general, the regulations provide that a change in the depreciation method, period of recovery, or convention of a depreciable or amortizable asset is a change in method of accounting. This change may be the result of, for example, a change in the classification of property under section 168(e) or a change in computing depreciation from the general depreciation system under section 168(a) to the alternative depreciation system of section 168(g). Further, a change to or from claiming the additional first year depreciation

deduction provided by section 168(k) or 1400L(b) is a change in method of accounting under certain circumstances.

The regulations clarify that the useful life exception, which has been moved from §1.446-1(e)(2)(ii)(b) to §1.446-1T(e)(2)(ii)(d), applies only to property for which the depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168). However, a change to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin is a change in method of accounting.

The regulations also provide that a change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, is treated as a change in method of accounting. Any other change in salvage value is not treated as a change in method of accounting.

Further, the regulations provide that a change in the accounting for depreciable or amortizable assets from single asset accounting to multiple asset accounting (pooling), or vice versa, or from one type of multiple asset accounting (pooling) to a different type of multiple asset accounting (pooling) is a change in method of accounting. Also, for depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed is a change in method of accounting (for example, from specific identification to a first-in, first-out method).

Finally, the regulations provide that a change in the treatment of an asset from nondepreciable or nonamortizable (nondepreciable) to depreciable or amortizable (depreciable), or vice versa, is a change in method of accounting. For example, a change in the treatment of an asset that was used entirely in the taxpayer's trade or business and was never held for sale from being treated as inventory to being treated as depreciable property is a change in method of accounting.

Exceptions

The regulations provide that a change in computing depreciation allowances in the taxable year in which the use of property changes in the hands of the same taxpayer is not a change in method of accounting.

The regulations also provide that the making of a late depreciation election or the revocation of a timely valid depreciation election generally is not a change in method of accounting. This rule also applies to the making of a late election or the revocation of a timely valid election under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). To make a late depreciation election or to revoke a timely valid depreciation election, a taxpayer must submit a request for a private letter ruling. Elections made under section 168(b)(2)(C), 168(b)(3)(D), or 168(g)(7) are irrevocable.

Finally, the regulations provide that any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting.

Item Being Changed

The regulations clarify that for purposes of changes in depreciation, the item being

changed is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to depreciable assets for which depreciation is determined under §1.167(a)-11 (CLADR property). Further, a change in computing depreciation under section 167 (other than a change under section 168, section 1400I, section 1400L, or former section 168) is permitted only with respect to all assets in a particular account (as defined in §1.167(a)-7) or vintage account.

Special Rules

The regulations also provide rules for the following: (1) a change from a declining balance method under section 168(b)(1) or (2) to the straight line method; (2) changes in certain depreciation methods under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168); and (3) section 481 adjustments.

With respect to a change from the 200-percent or 150-percent declining balance method under section 168(b)(1) or (2) to the straight line method, the regulations provide that this change may be made without the consent of the Commissioner in the first taxable year in which the depreciation allowance under the straight line method is greater than the depreciation allowance under the declining balance method.

With respect to changes in depreciation methods under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168), the regulations provide cross-references to regulations under section 167 that allow certain depreciation method changes to be made without the consent of the Commissioner.

With respect to section 481 adjustments, the regulations also clarify that except as

otherwise expressly provided by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, a change from one permissible method of computing depreciation to another permissible method of computing depreciation for a depreciable or amortizable asset is implemented on either a cut-off method (as described in section 2.06 of Rev. Proc. 97-27 (1997-1 C.B. 680) and in section 2.06 of Rev. Proc. 2002-9 (2002-1 C.B. 327)) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting). Because no items are duplicated or omitted from income when the cut-off method or the modified cut-off method is used to effect the change in method of accounting, no section 481 adjustment is required or permitted. However, a change from an impermissible method of computing depreciation to a permissible method of computing depreciation results in a negative or positive section 481 adjustment because the adjusted depreciable basis of the asset as of the beginning of the year of change is changed as a result of the change in computing depreciation. Similarly, a change in the treatment of an asset from nondepreciable to depreciable (or vice versa) or a change from expensing to depreciating an asset (or vice versa) will also result in a negative or positive section 481 adjustment.

Application of the Allowed or Allowable Rule to Changes in Method of Accounting

Section 1016(a)(2) provides that the basis of property is adjusted in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount allowed as deductions in computing taxable income and resulting in a reduction for any taxable year of the

taxpayer's taxes, but not less than the amount allowable.

Concurrently with the issuance of these regulations, the IRS and Treasury Department will issue a revenue procedure that will allow a taxpayer to change the taxpayer's method of determining depreciation for a depreciable or amortizable asset after its disposition if the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable, for the asset in computing taxable income in the year of disposition or in prior taxable years. Because the taxpayer is permitted to claim the allowable depreciation not taken into account for this asset, the taxpayer's lifetime income is not permanently affected by the "allowed or allowable" rule under section 1016(a)(2). Accordingly, the regulations provide that section 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation is a change in method of accounting under section 446(e) and the regulations under section 446(e).

The revenue procedure also will revise the depreciation changes included in Rev. Proc. 2002-9 (2002-1 C.B. 327), the automatic change in method of accounting revenue procedure, to conform with these regulations and will waive the application of Rev. Rul. 90-38 (1990-1 C.B. 57) for changes in depreciation made under Rev. Proc. 97-27 (1997-1 C.B. 680) or Rev. Proc. 2002-9.

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. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the **Federal Register**. Pursuant to section 7805(f) of the Code, these temporary regulations will be 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 Sara Logan, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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 1.167(e)-1 is amended by:

1. Revising paragraph (a).
2. Adding new paragraph (e).

The addition and revision read as follows:

§1.167(e)-1 Change in method.

(a) In general. [Reserved]. For further guidance, see §1.167(e)-1T(a).

* * * * *

(e) Effective date. [Reserved]. For further guidance, see the first two sentences of §1.167(e)-1T(e).

Par. 3. Section 1.167(e)-1T is added to read as follows:

§1.167(e)-1T Change in method (temporary).

(a) In general. (1) Any change in the method of computing the depreciation allowances with respect to a particular account (other than a change in method permitted or required by reason of the operation of former section 167(j)(2) and §1.167(j)-3(c)) is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that certain changes to the straight line method of depreciation will be permitted without consent as provided in former section 167(e)(1), (2), and (3). Except as provided in paragraphs (c) and (d) of this section, a change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in §1.167(a)-7. Any change in the percentage of the current straight line rate under the declining balance method, for example, from 200 percent of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method, will constitute a change in method of depreciation. Any request for a change in method of depreciation shall be made in accordance with section 446(e) and the regulations under section 446(e). For rules covering the use of depreciation methods by acquiring corporations in the case

of certain corporate acquisitions, see section 381(c)(6) and the regulations under section 381(c)(6).

(2) Paragraphs (b), (c), and (d) of this section apply to property for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or under section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121)) of the Internal Revenue Code.

(b) through (d) [Reserved]. For further guidance, see §1.167(e)-1(b) through (d).

(e) Effective date. This section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.167(e)-1 in effect prior to December 30, 2003 (§1.167(e)-1 as contained in 26 CFR part 1 edition revised as of April 1, 2003). The applicability of this section expires on or before January 2, 2007.

Par. 4. Section 1.446-1 is amended by:

1. Revising paragraphs (e)(2)(ii)(a), (e)(2)(ii)(b), and (e)(2)(iii).

2. Adding new paragraphs (e)(2)(ii)(d) and (e)(4).

The additions and revisions read as follows:

§1.446-1 General rule for methods of accounting.

* * * * *

(e) * * *

(2) * * *

(ii) (a) [Reserved]. For further guidance, see §1.446-1T(e)(2)(ii)(a).

(b) [Reserved]. For further guidance, see §1.446-1T(e)(2)(ii)(b).

* * * * *

(d) Changes involving depreciable or amortizable assets. [Reserved]. For further guidance, see §1.446-1T(e)(2)(ii)(d).

(iii) Examples. [Reserved]. For further guidance, see §1.446-1T(e)(2)(iii).

* * * * *

(4) Effective date. [Reserved]. For further guidance, see §1.446(e)-1T(e)(4)(i) and (ii).

Par. 5. Section 1.446-1T is added to read as follows:

§1.446-1T General rule for methods of accounting (temporary).

(a) through (e)(2)(i) [Reserved]. For further guidance, see §1.446-1(a) through (e)(2)(i).

(e)(2)(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or vice versa (see §1.460-4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of

this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(d) of this section and §1.1016-3T(h).

(c) [Reserved]. For further guidance, see §1.446-1(e)(2)(ii)(c).

(d) Changes involving depreciable or amortizable assets--(1) Scope. This paragraph (e)(2)(ii)(d) applies to property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168).

(2) Changes in depreciation or amortization that are a change in method of accounting. Except as provided in paragraph (e)(2)(ii)(d)(3) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(d)(3) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

(i) A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

(ii) A change from not claiming to claiming the additional first year depreciation deduction provided by section 168(k) or 1400L(b) for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property, provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a

deemed election out of the additional first year depreciation deduction; for further guidance, see Rev. Proc. 2002-33 (2002-1 C.B. 963), Rev. Proc. 2003-50 (2003-29 I.R.B. 119), and §601.601(d)(2)(ii)(b) of this chapter) for the class of property in which the qualified property, the 50-percent bonus depreciation property, or the qualified New York Liberty Zone property is included.

(iii) A change from claiming the 30-percent additional first year depreciation deduction to claiming the 50-percent additional first year depreciation deduction for 50-percent bonus depreciation property (provided the property is not included in any class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction) or a change from claiming the 50-percent additional first year depreciation deduction to claiming the 30-percent additional first year depreciation deduction for qualified property (including property that is included in a class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction) or qualified New York Liberty Zone property, and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(d)(2)(iii) does not apply if a taxpayer is making a late election or revoking a timely valid election under section 168(k) or 1400L(b) (see paragraph (e)(2)(ii)(d)(3)(iii) of this section).

(iv) A change from claiming to not claiming the additional first year depreciation deduction for an asset that is not qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property, and the resulting change to the

amount otherwise allowable as a depreciation deduction for the property's depreciable basis.

(v) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4)), the regulations under the Code (for example, §1.197-2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

(vi) A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).

(vii) For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(d)(2)(vii), the term mass assets means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

(viii) Any other change in depreciation or amortization as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(3) Changes in depreciation or amortization that are not a change in method of accounting--(i) Useful life. An adjustment in the useful life of a depreciable or amortizable

asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168) is not a change in method of accounting. This adjustment in useful life is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)-1(b) (or if the period of limitation for assessment under section 6501(a) has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations, the adjustment in useful life may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the Internal Revenue Service (IRS) but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the correction in useful life, in lieu of filing amended federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)-1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years. This paragraph (e)(2)(ii)(d)(3)(i) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1), section 168(c), section 197), the regulations under the Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(d)(3)(v) of this section applies).

(ii) Change in use. A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

(iii) Elections. Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(d)(3)(iii) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling.

(iv) Salvage value. Except as provided under paragraph (e)(2)(ii)(d)(2)(v) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

(v) Placed-in-service date. Any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. The change in placed-in-service date may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended federal tax returns,

the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

(vi) Any other change in depreciation or amortization as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(4) Item being changed. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under §1.167(a)-11 (CLADR property). Further, a change in computing depreciation or amortization under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168) is permitted only with respect to all assets in a particular account (as defined in §1.167(a)-7) or vintage account.

(5) Special rules. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies--

(i) Declining balance method to the straight line method for MACRS property. For tangible, depreciable property subject to section 168 (MACRS property) that is depreciated using the 200-percent or 150-percent declining balance method of depreciation under section 168(b)(1) or (2), a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method of depreciation in the first taxable year in which the use of the straight line method

with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. 87-57 (1987-2 C.B. 687) and §601.601(d)(2)(ii)(b) of this chapter).

(ii) Depreciation method changes for section 167 property. For a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168), see §1.167(e)-1T(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see §1.167(a)-11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see §1.167(a)-11(b)(4)(iii)(c) for how to correct an incorrect classification or characterization of CLADR property.

(iii) Section 481 adjustment. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, no section 481 adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, see section 2.06 of Rev. Proc. 97-27 (1997-1 C.B. 680), section 2.06 of Rev. Proc. 2002-9 (2002-1 C.B. 327), and

§601.601(d)(2)(ii)(b) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa) or a change in the treatment of an asset from expensing to depreciating (or vice versa) results in a section 481 adjustment.

(iii) Examples. The rules of this paragraph (e) are illustrated by the following examples:

Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example 2. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example 3. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises.

The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example 4. From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example 5. A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

Example 6. A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example 7. A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example 8. A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

Example 9. In 2000, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of $10,000,000 for use in its manufacturing operations. A1 classified the $10,000,000 as nonresidential real property under section 168(e). A1 did

not make any elections under section 168 on its 2000 Federal tax return. As a result, on its 2000, 2001, and 2002 federal tax returns, A1 depreciated the $10,000,000 under the general depreciation system of section 168(a), using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. In 2003, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of $1,500,000 as section 1245 property. As a result, the $1,500,000 should have been classified in 2000 as 5-year property under section 168(e) and depreciated on A1's 2000, 2001, and 2002 Federal tax returns under the general depreciation system, using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, A1's change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

Example 10. In 1996, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $1,000,000 for use in its plant located outside the United States. The equipment is 15-year property under section 168(e) with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g). However, B incorrectly depreciated the equipment under the general depreciation system of section 168(a), using the 150-percent declining balance method, a 15-year recovery period, and the half-year convention. In 2003, the IRS examines B's 2000 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

Example 11. In May 2001, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. C never held this equipment for sale. However, C incorrectly treated the equipment as inventory on its 2001 and 2002 Federal tax returns. In 2003, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, C's change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 adjustment.

Example 12. Since 2001, D, a calendar year taxpayer, has used the distribution fee period method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000-38 (2000-2 C.B. 310) and §601.601(d)(2)(ii)(b) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from

pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(d)(2)(vi) of this section. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 13. Since 2000, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identified any dispositions of these mass assets by specific identification. Because of changes in E's recordkeeping in 2003, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(d)(2)(vii) of this section, this change is a change in method of accounting. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 14. In August 2001, F, a calendar taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7-year property under section 168(e). F made no elections under section 168 on its 2001 Federal tax return. As a result, on its 2001 and 2002 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a), using the 200-percent declining balance method of depreciation, a 7-year recovery period, and the half-year convention. In 2003, F realizes that the copier is 5-year property and should have been depreciated on its 2001 and 2002 Federal tax returns under the general depreciation system using a 5-year recovery period rather than a 7-year recovery period. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, F's change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the copier is depreciated under section 168.

Example 15. In 1998, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 intangible and that is not described in section 167(f). G amortized the cost of the intangible asset under section 167(a) using the straight line method of depreciation and a useful life of 13 years. In 2003, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(d)(3)(i) of this section, G's change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin.

Example 16. In July 2001, H, a calendar year taxpayer, purchased and placed in service "off-the-shelf" computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5-year property under section 168(e). On its 2001 Federal tax return, H elected to depreciate its 5-year property placed in service in 2001 under the alternative depreciation system of section 168(g). The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5-year recovery period, and the half-year convention. In 2003, H realizes that the cost of the software should have been amortized under section 167(f)(1), using the straight line method of depreciation, a 36-month useful life, and a monthly convention. H's change from 5-years to 36-months is a change in method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1). The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 adjustment.

Example 17. On September 15, 2001, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $500,000 for use in its business. The equipment is 5-year property under section 168(e) with a class life of 9 years and is qualified property under section 168(k). I2 did not place in service any other depreciable property in 2001. Section 168(g)(1)(A) through (D) do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) for 5-year property placed in service in 2001. However, I2 did not make the election. Instead, I2 deducted on its 2001 Federal tax return the 30-percent additional first year depreciation attributable to the equipment and, on its 2001 and 2002 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In 2003, I2 realizes its failure to make the alternative depreciation system election in 2001 and files a Form 3115 to change its method of depreciating the remaining adjusted depreciable basis of the 2001 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2001) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(d)(3)(iii) of this section. Instead, I2 must submit a request for a private letter ruling under §301.9100-3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2001 Federal tax return.

(3) [Reserved]. For further guidance, see §1.446-1(e)(3).

(4) Effective date--(i) In general. Except as provided in paragraphs (e)(3)(iii) and (e)(4)(ii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.446-1(e) in effect prior to December 30, 2003 (§1.446-1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) Changes involving depreciable or amortizable assets. With respect to paragraph (e)(2)(ii)(d) of this section, paragraph (e)(2)(iii) Examples 9 through 17 of this section, the addition of the language "certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section)" to the last sentence of paragraph (e)(2)(ii)(a) of this section, and the removal of all language regarding useful life and the sentence "On the other hand, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting" from paragraph (e)(2)(ii)(b) of this section--

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made for taxable years ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made for taxable years ending on or after December 30, 2003.

(iii) The applicability of paragraph (e) of this section expires on or before January 2,

2007.

Par. 6. Section 1.1016-3 is amended by:

1. Redesignating paragraph (h) as paragraph (i).

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

The additions read as follows:

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

* * * * *

(h) Application to a change in method of accounting. [Reserved]. For further guidance, see §1.1016-3T(h).

* * * * *

(j) Effective date. [Reserved]. For further guidance, see §1.1016-3T(j)(1) and (2).

Par. 7. Section 1.1016-3T is added to read as follows:

§1.1016-3T Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913 (temporary).

(a) through (g) [Reserved]. For further guidance, see §1.1016-3(a) through (g).

(h) Application to a change in method of accounting. For purposes of determining whether a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168) is a change in method of accounting under section 446(e) and the regulations under section 446(e), section 1016(a)(2) does not permanently affect a taxpayer's lifetime income.

(i) [Reserved]. For further guidance, see §1.1016-3(i).

(j) Effective date--(1) In general. Except as provided in paragraph (j)(2) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.1016-3 in effect prior to December 30, 2003 (§1.1016-3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(2) Depreciation or amortization changes. Paragraph (h) of this section applies to a change in depreciation or amortization for property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or former section 168 for taxable years ending on or after December 30, 2003.

(3) The applicability of this section expires on or before January 2, 2007.

December 16, 2003

Deputy Commissioner for Services and Enforcement.

Mark E. Matthews

Approved: December 18, 2003

Assistant Secretary of the Treasury (Tax Policy).
Pamela F. Olson

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 1016; 1.446-1T, 1.1016-3T.)

Rev. Proc. 2004-11

SECTION 1. PURPOSE

This revenue procedure provides an automatic consent procedure allowing a taxpayer to make a change in method of accounting under § 446(e) of the Internal Revenue Code for depreciable or amortizable property after its disposition. This revenue procedure also waives the application of the two-year rule set forth in Rev. Rul. 90-38, 1990-1 C.B. 57, for certain changes in depreciation or amortization. Finally, this revenue procedure modifies Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified by Rev. Proc. 2002-54, 2002-2 C.B. 432, Rev. Proc. 2002-19, 2002-1 C.B. 696, Rev. Proc. 2002-33, 2002-1 C.B. 963, and as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561), and other revenue procedures to conform with § 1.446-1T(e)(2)(ii)(d) of the temporary Income Tax Regulations.

SECTION 2. BACKGROUND

.01 Section 446(e) and § 1.446-1T(e) provide that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner of Internal Revenue before changing a method of accounting for federal income tax purposes. Section 1.446-1T(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting.

.02 Concurrently with the issuance of this revenue procedure, §§ 1.446-1T(e)(2)(ii)(d) and 1.1016-3T(h) have been promulgated. Section 1.446-1T(e)(2)(ii)(d) provides the changes in depreciation or amortization (hereinafter, both are referred to as "depreciation") that are (and are not) changes in method of accounting under § 446(e). Section 1.1016-3T(h) provides that the "allowed or allowable" rule under § 1016(a)(2) does not permanently affect a taxpayer's lifetime income for purposes of determining whether a change in depreciation or amortization is a change in method of accounting under § 446(e).

.03 If a taxpayer uses an impermissible method of determining depreciation for a depreciable or amortizable property, the taxpayer adopts that method of accounting for the property when the taxpayer treats the property in the same way in determining gross income or deductions in two or more consecutively filed federal tax returns. See Rev. Rul. 90-38. The Internal Revenue Service and Treasury Department recognize that this two-year rule increases administrative and compliance costs associated with changes in

depreciation because many taxpayers changing from an impermissible to permissible method of accounting for depreciation used the impermissible method for depreciable or amortizable properties placed in service in two or more taxable years before the year of change as well as for depreciable and amortizable properties placed in service in the taxable year immediately preceding the year of change. Accordingly, in the interest of sound tax administration, the Service and Treasury Department have decided to waive the two-year rule in Rev. Rul. 90-38 for a change in depreciation to which § 1.446-1T(e)(2)(ii)(d) applies.

.04 If a depreciable or amortizable property is transferred in a transaction in which the transferee is treated as the transferor for purposes of computing the depreciation allowance for the property with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted depreciable basis in the hands of the transferor (for example, in transactions subject to § 168(i)(7) or § 381(c)(6)), the transferee may file a Form 3115, Application for Change in Accounting Method, to change from an impermissible method of accounting adopted by the transferor for that portion of the basis of the property to a permissible method of accounting for depreciation for the same portion of the basis of the property, provided the impermissible method of accounting for that portion of the basis of the property has not been changed by the transferor (through filing, for example, a Form 3115 or an amended return) or by the Internal Revenue Service upon examination of the transferor's tax returns. In this case, the § 481 adjustment will include any necessary adjustments since the property's placed-in-service date by the transferor.

SECTION 3. METHOD CHANGE PROCEDURE FOR DISPOSED DEPRECIABLE OR AMORTIZABLE PROPERTY

.01 Scope.

(1) Applicability. Except as provided in section 3.01(2) of this revenue procedure, section 3 of this revenue procedure applies to a taxpayer that is changing from an impermissible method of accounting for depreciation to a permissible method of accounting for depreciation for any item of depreciable or amortizable property subject to § 1.446-1T(e)(2)(ii)(d):

(a) that has been disposed of by the taxpayer during the year of change (as defined in section 3.02(2)(b) of this revenue procedure); and

(b) for which the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable (hereinafter, both are referred to as "claimed less than the depreciation allowable"), in the year of change (as defined in section 3.02(2)(b) of this revenue procedure) or any prior taxable year.

(2) Inapplicability. Section 3 of this revenue procedure does not apply to:

(a) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(b) any property for which a taxpayer is revoking a timely valid depreciation election, or making a late depreciation election, under the Code or regulations thereunder, or under other guidance published in the Internal Revenue Bulletin

(including under § 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993, 1993-3 C.B. 1, 128 (relating to amortizable § 197 intangibles));

(c) any property for which the taxpayer deducted the cost or other basis of the property as an expense; or

(d) any property disposed of by the taxpayer in a transaction to which a nonrecognition section of the Code applies (for example, § 1031, transactions subject to § 168(i)(7)(B)(i)). However, this section 3.01(2)(d) does not apply to property disposed of by the taxpayer in a § 1031 or § 1033 transaction if the taxpayer elects to treat the entire basis (that is, both the carryover and excess basis) of the acquired MACRS property as property placed in service by the taxpayer at the time of replacement and treat the adjusted depreciable basis of the exchanged or involuntarily converted MACRS property as being disposed of by the taxpayer at the time of disposition.

.02 Change in method of accounting.

(1) In general. A taxpayer within the scope of section 3 of this revenue procedure may change from an impermissible method of accounting for depreciation to a permissible method of accounting for depreciation for any item of depreciable or amortizable property within the scope of section 3 of this revenue procedure, provided:

(a) the taxpayer files the original Form 3115 in accordance with section 3.02(2)(c) of this revenue procedure, prior to the expiration of the period of limitation for assessment under § 6501(a) for the taxable year in which the item of depreciable or amortizable property was disposed of by the taxpayer; and

(b) the taxpayer files an amended federal tax return for the year of change (as defined in section 3.02(2)(b) of this revenue procedure) that includes the adjustments to taxable income and any collateral adjustments to taxable income or tax liability (for example, adjustments to the amount or character of the gain or loss of the disposed depreciable or amortizable property) resulting from the change in method of accounting for depreciation made by the taxpayer under this section 3.

(2) Application Procedures. A taxpayer making a change in method of accounting under section 3 of this revenue procedure must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9 (or its successor), with the following modifications:

(a) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply. If the taxpayer is under examination, before an appeals office, or before a federal court at the time that a copy of the Form 3115 is filed with the national office, the taxpayer must provide a copy of the Form 3115 to the examining agent, appeals officer, or counsel for the government, as appropriate, at the time the copy of the Form 3115 is filed with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent, appeals officer, or counsel for the government, as appropriate.

(b) The year of change is the taxable year in which the item of depreciable or amortizable property was disposed of by the taxpayer.

(c) Section 6.02(3)(a) of Rev. Proc. 2002-9 is modified to require the original of the Form 3115 to be attached to the taxpayer's timely filed amended federal tax

return for the year of change and a copy (with signature) of the Form 3115 to be filed with the national office no later than when the original Form 3115 is filed with the amended federal tax return for the year of change.

(d) For purposes of section 6.02(4)(a) of Rev. Proc. 2002-9, the taxpayer should include on line 1a of the Form 3115 (revised December 2003) the designated automatic accounting method change number for the change in method of accounting for depreciation made under this section 3. This number for this method change is "9."

SECTION 4. WAIVER OF TWO-YEAR RULE IN REV. RUL. 90-38

.01 In general. Notwithstanding Rev. Rul. 90-38, a taxpayer may file a Form 3115 under Rev. Proc. 97-27, 1997-1 C.B. 680 (or its successor), or Rev. Proc. 2002-9, as applicable, to change from an impermissible method of accounting for depreciation to a permissible method of accounting for depreciation under § 1.446-1T(e)(2)(ii)(d) for any depreciable or amortizable property subject to § 1.446-1T(e)(2)(ii)(d) and placed in service by the taxpayer in the taxable year immediately preceding the year of change (as defined in section 5.02(2) of Rev. Proc. 97-27 or section 5.02 of Rev. Proc. 2002-9, as applicable) (hereinafter, this property is referred to as "1-year depreciable property"), provided the additional term and condition in section 4.02 of this revenue procedure is satisfied. Alternatively, the taxpayer may make the change from the impermissible depreciation method to the permissible depreciation method for the 1-year depreciable property by filing an amended federal tax return for the placed-in-service year prior to the date the

taxpayer files its federal tax return for the taxable year succeeding the placed-in-service year.

.02 Additional term and condition for filing a Form 3115. In addition to the terms and conditions provided in Rev. Proc. 97-27 or Rev. Proc. 2002-9, as applicable, the § 481 adjustment reported on a Form 3115 that is filed by a taxpayer in accordance with section 4.01 of this revenue procedure to make a change in method of accounting for depreciation under § 1.446-1T(e)(2)(ii)(d) for any 1-year depreciable property, must include the amount of any adjustment attributable to all property (including the 1-year depreciable property) subject to the Form 3115.

SECTION 5. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 2002-9 is modified and amplified to include the accounting method change provided under section 3 of this revenue procedure in section 2.05 of the APPENDIX. See section 4 of the APPENDIX of this revenue procedure for the text of section 2.05 of the APPENDIX of Rev. Proc. 2002-9.

.02 The heading for section 2 of the APPENDIX of Rev. Proc. 2002-9 is modified to read as follows: "SECTION 2. DEPRECIATION OR AMORTIZATION (§ 56(a)(1), 56(g)(4)(A), 167, 168, 197, 1400I, OR 1400L, OR FORMER § 168)".

.03 Rev. Proc. 2002-9 (as modified by Rev. Proc. 2002-33) is modified by deleting sections 2.01, 2.02, and 2B of the APPENDIX and replacing them with the text in, respectively, sections 1, 2, and 3 of the APPENDIX of this revenue procedure.

.04 Section 6.03 of Rev. Proc. 2000-38, 2000-2 C.B. 310, 313, is modified by

deleting "See § 1.446-1(e)(2)(ii)(b)." and replacing it with "See § 1.446-1T(e)(2)(ii)(d)(3)(i)."

.05 Section 8.01 of Rev. Proc. 2000-50, 2000-2 C.B. 601, is modified to read as follows: "A change in a taxpayer's treatment of costs paid or incurred to develop, purchase, lease, or license computer software to a method described in section 5, 6, or 7 of this revenue procedure is a change in method of accounting to which §§ 446 and 481 apply. Further, a change in useful life under the method described in section 5.01(2) or 6.01(2) of this revenue procedure is a change in method of accounting. See § 1.446-1T(e)(2)(ii)(d)(3)(i) and, for the effective date, see § 1.446-1T(e)(4)(ii)(A)."

SECTION 6. EFFECTIVE DATE

.01 In general. Except as provided in section 6.02 of this revenue procedure, this revenue procedure is effective for a Form 3115 filed for taxable years ending on or after December 30, 2003.

.02 Transition rule for previously filed Forms 3115 for automatic consent.

(1) For a taxable year ending on or after December 30, 2003, a taxpayer may make a change in method of accounting previously authorized in section 2.01, 2.02, or 2B of the APPENDIX of Rev. Proc. 2002-9 before any amendments were made to those sections by this revenue procedure if:

(a) before December 30, 2003, the taxpayer filed a completed Form 3115 with the national office to make that change in method of accounting; and

(b) the taxpayer makes that change in method of accounting in

compliance with all the applicable provisions of Rev. Proc. 2002-9 for the requested year of change (as defined in section 5.02 of Rev. Proc. 2002-9) on that Form 3115.

(2) If a taxpayer filed a Form 3115 with the national office to make a change in method of accounting previously authorized in section 2.01, 2.02, or 2B of the APPENDIX of Rev. Proc. 2002-9 before any amendments were made to those sections by this revenue procedure for a year of change for which this revenue procedure is effective (see section 6.01 of this revenue procedure) and the taxpayer's original federal tax return for that year of change was not filed before December 30, 2003, the taxpayer may make the change in method of accounting authorized under section 2.01, 2.02, or 2B, as applicable, of the APPENDIX of Rev. Proc. 2002-9 as revised by this revenue procedure. However, the Service will process the Form 3115 in accordance with the section of the APPENDIX of Rev. Proc. 2002-9 in effect on the date on which the Form 3115 was filed with the national office by the taxpayer unless on or before the due date (including extensions) of the taxpayer's federal tax return for the requested year of change (as defined in section 5.02 of Rev. Proc. 2002-9) on that Form 3115, the taxpayer completes a new Form 3115 to make the change under section 2.01, 2.02, or 2B, as applicable, of the APPENDIX of Rev. Proc. 2002-9 as revised by this revenue procedure and files this newly completed Form 3115 in duplicate in accordance with section 6.02(3)(a) of Rev. Proc. 2002-9. Additionally, the newly completed Form 3115 must include the statement: "Section [insert, as appropriate: 2.01, 2.02, or 2B] of the APPENDIX of Rev. Proc. 2002-9 as revised by Rev. Proc. 2004-11." This statement must be legibly printed or typed on the

appropriate line on, or at the top of page 1 of, the Form 3115.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Sara Logan of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Logan or Douglas Kim on (202) 622-3110 (not a toll free call).

APPENDIX

SECTION 1. Section 2.01 of the APPENDIX of Rev. Proc 2002-9 is deleted and replaced with the following:

".01 Impermissible to permissible method of accounting for depreciation or amortization.

(1) Description of change and scope.

(a) Applicability. This change applies to a taxpayer that wants to change from an impermissible to a permissible method of accounting for depreciation or amortization (depreciation) for any item of depreciable or amortizable property:

(i) for which the taxpayer used the impermissible method of accounting in at least the two taxable years immediately preceding the year of change (but see section 2.01(1)(b) of this APPENDIX for property placed in service in the taxable year immediately preceding the year of change);

(ii) for which the taxpayer is making a change in method of accounting under § 1.446-1T(e)(2)(ii)(d);

(iii) for which depreciation is determined under § 56(a)(1), § 56(g)(4)(A), § 167, § 168, § 197, § 1400I, § 1400L(b), or § 1400L(c), or under § 168 prior to its amendment in 1986 (former § 168); and

(iv) that is owned by the taxpayer at the beginning of the year of change (but see section 2.05 of this APPENDIX for property disposed of before the year of change).

(b) Taxpayer has not adopted a method of accounting for the item of property. If a taxpayer does not satisfy section 2.01(1)(a)(i) of this APPENDIX for an item of depreciable or amortizable property because this item of property is placed in service by the taxpayer in the taxable year immediately preceding the year of change ("1-year depreciable property"), the taxpayer may change from the impermissible depreciation method to the permissible depreciation method for the 1-year depreciable property by filing a Form 3115 for this change, provided the § 481 adjustment reported on the Form 3115 includes the amount of any adjustment that is attributable to all property (including the 1-year depreciable property) subject to the Form 3115. Alternatively, the taxpayer may change from the impermissible depreciation method to the permissible depreciation method for a 1-year depreciable property by filing an amended federal tax return for the property's placed-in-service year prior to the date the taxpayer files its federal tax return for the taxable year succeeding the
placed-in-service year.

(c) Certain scope limitations inapplicable. The scope limitations in sections 4.02(7) and 4.02(8) of this revenue procedure are not applicable to this change.

(d) Inapplicability. This change does not apply to:

(i) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(ii) any taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 2.01 of this APPENDIX, if the taxpayer is not capitalizing the

costs as required;

(iii) any property for which a taxpayer is making a change in depreciation under § 1.446-1T(e)(2)(ii)(d)(2)(vi) or (vii);

(iv) any property subject to § 167(g) (regarding property depreciated under the income forecast method);

(v) any § 1250 property that a taxpayer is reclassifying to an asset class of Rev. Proc. 87-56, 1987-2 C.B. 674, or Rev. Proc. 83-35, 1983-1 C.B. 745, as appropriate, that does not explicitly include § 1250 property (for example, asset class 57.0, Distributive Trades and Services);

(vi) any property for which a taxpayer is revoking a timely valid election, or making a late election, under § 167, § 168, § 1400I, § 1400L, former § 168, or § 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (1993 Act), 1993-3 C.B. 1, 128 (relating to amortizable § 197 intangibles). A taxpayer may request consent to revoke or make the election by submitting a request for a letter ruling under Rev. Proc. 2003-1, 2003-1 I.R.B. 1 (or any successor). See § 1.446-1T(e)(2)(ii)(d)(3)(iii);

(vii) any property for which depreciation is determined under § 56(g)(4)(A) or § 167 (other than under § 168, § 1400I, § 1400L, or former § 168) and a taxpayer is changing the useful life of the property. A change in the useful life of property is corrected by adjustments in the applicable taxable year provided under § 1.446-1T(e)(2)(ii)(d)(3)(i). However, this section 2.01(1)(d)(vii) of this APPENDIX does not apply if the taxpayer is changing to or from a useful life, recovery period, or amortization

period that is specifically assigned by the Internal Revenue Code (for example, § 167(f)(1), § 168(c)), the regulations thereunder, or other guidance published in the Internal Revenue Bulletin and, therefore, this change is a change in method of accounting (unless section 2.01(1)(d)(xv) of this APPENDIX applies). See § 1.446-1T(e)(2)(ii)(d)(3)(i);

(viii) any depreciable property for which the use changes in the hands of the same taxpayer. See § 1.446-1T(e)(2)(ii)(d)(3)(ii);

(ix) any property for which depreciation is determined in accordance with § 1.167(a)-11 (regarding the Class Life Asset Depreciation Range System (ADR));

(x) any change in method of accounting involving a change from deducting the cost or other basis of any property as an expense to capitalizing and depreciating the cost or other basis;

(xi) any change in method of accounting involving a change from one permissible method of accounting for the property to another permissible method of accounting for the property. For example:

(A) a change from the straight-line method of depreciation to the income forecast method of depreciating for videocassettes. See Rev. Rul. 89-62, 1989-1 C.B. 78; or

(B) a change from charging the depreciation reserve with costs of removal and crediting the depreciation reserve with salvage proceeds to deducting costs of removal as an expense (provided the costs of removal are not required

to be capitalized under any provision of the Code, such as, § 263(a)) and including salvage proceeds in taxable income (see section 2.02 of this APPENDIX for making this change for property for which depreciation is determined under § 167);

(xii) any change in method of accounting involving both a change from treating the cost or other basis of the property as nondepreciable or nonamortizable property to treating the cost or other basis of the property as depreciable or amortizable property and the adoption of a method of accounting for depreciation requiring an election under § 167, § 168, § 1400I, § 1400L(b), former § 168, or § 13261(g)(2) or (3) of the 1993 Act (for example, a change in the treatment of the space consumed in landfills placed in service in 1990 from nondepreciable to depreciable property (assuming section 2.01(1)(d)(xiii) of the APPENDIX does not apply) and the making of an election under § 168(f)(1) to depreciate this property under the unit of production method of depreciation under § 167);

(xiii) any change in method of accounting for any item of income or deduction other than depreciation, even if the change results in a change in computing depreciation under § 1.446-1T(e)(2)(ii)(d)(2)(i), (ii), (iii), (iv), (v), (vi), (vii), or (viii). For example, a change in method of accounting involving:

(A) a change in inventory costs (for example, when property is reclassified from inventory property to depreciable property, or vice versa) (but see section 3.02 of this APPENDIX for making a change from inventory property to depreciable property for unrecoverable line pack gas or unrecoverable cushion gas); or

(B) a change in the character of a transaction from sale

to lease, or vice versa (but see section 2.03 of this APPENDIX for making this change);

(xiv) a change from determining depreciation under § 168 to determining depreciation under former § 168 for any property subject to the transition rules in § 203(b) or 204(a) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1, 60-80; or

(xv) any change in the placed-in-service date of a depreciable or amortizable property. This change is corrected by adjustments in the applicable taxable year provided under § 1.446-1T(e)(2)(ii)(d)(3)(v).

(2) Additional requirements. A taxpayer also must comply with the following:

(a) Permissible method of accounting for depreciation. A taxpayer must change to a permissible method of accounting for depreciation for the item of depreciable or amortizable property. The permissible method of accounting is the same method that determines the depreciation allowable for the item of property (as provided in section 2.01(5) of this APPENDIX).

(b) Statements required. A taxpayer must provide the following statements, if applicable, and attach them to the completed application:

(i) a detailed description of the former and new methods of accounting. A general description of these methods of accounting is unacceptable (for example, MACRS to MACRS, erroneous method to proper method, claiming less than the depreciation allowable to claiming the depreciation allowable);

(ii) to the extent not provided elsewhere on the application, a statement describing the taxpayer's business or income-producing activities. Also, if the taxpayer has more than one business or income-producing activity, a statement describing

the taxpayer's business or income-producing activity in which the item of property at issue is primarily used by the taxpayer;

(iii) to the extent not provided elsewhere on the application, a statement of the facts and law supporting the new method of accounting, new classification of the item of property, and new asset class in, as appropriate, Rev. Proc. 87-56 or Rev. Proc. 83-35. If the taxpayer is the owner and lessor of the item of property at issue, the statement of the facts and law supporting the new asset class also must describe the business or income-producing activity in which that item of property is primarily used by the lessee;

(iv) to the extent not provided elsewhere on the application, a statement identifying the year in which the item of property was placed in service;

(v) if the item of property is depreciated under former § 168, a statement identifying the asset class in Rev. Proc. 83-35 that applies under the taxpayer's former and new methods of accounting (if none, state and explain);

(vi) if any item of property is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A), as applicable, a statement providing that the taxpayer agrees to the following additional terms and conditions:

(A) a normalization method of accounting (within the meaning of former § 167(l)(3)(G), former § 168(e)(3)(B), or § 168(i)(9), as applicable) will be used for the public utility property subject to the application;

(B) as of the beginning of the year of change, the taxpayer will adjust its deferred tax reserve account or similar reserve account in the

taxpayer's regulatory books of account by the amount of the deferral of federal income tax liability associated with the § 481(a) adjustment applicable to the public utility property subject to the application; and

(C) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer will provide a copy of the completed application to any regulatory body having jurisdiction over the public utility property subject to the application;

(vii) if the taxpayer is changing the classification of an item of § 1250 property placed in service after August 19, 1996, to a retail motor fuels outlet under § 168(e)(3)(E)(iii), a statement containing the following representation: "For purposes of § 168(e)(3)(E)(iii) of the Internal Revenue Code, the taxpayer represents that (A) 50 percent or more of the gross revenue generated from the item of § 1250 property is from the sale of petroleum products (not including gross revenue from related services, such as the labor cost of oil changes and gross revenue from the sale of nonpetroleum products such as tires and oil filters), (B) 50 percent or more of the floor space in the item of property is devoted to the sale of petroleum products (not including floor space devoted to related services, such as oil changes and floor space devoted to nonpetroleum products such as tires and oil filters), or (C) the time of § 1250 property is 1,400 square feet or less."; and

(viii) if the taxpayer is changing the classification of an item of property from § 1250 property to § 1245 property under § 168 or former § 168, a statement of the facts and law supporting the new § 1245 property classification, and a statement containing the following representation: "Each item of depreciable property that is the

subject of the application filed under section 2.01 of the APPENDIX of Rev. Proc. 2002-9 for the year of change beginning [Insert the date], and that is reclassified from [Insert, as appropriate: nonresidential real property, residential rental property, 19-year real property, 18-year real property, or 15-year real property] to an asset class of [Insert, as appropriate, either: Rev. Proc. 87-56, 1987-2 C.B. 674, or Rev. Proc. 83-35, 1983-1 C.B. 745] that does not explicitly include § 1250 property, is § 1245 property for depreciation purposes."

(3) Section 481(a) adjustment. Because the adjusted basis of the property is changed as a result of a method change made under section 2.01 of this APPENDIX (see section 2.01(4) of this APPENDIX), items are duplicated or omitted. Accordingly, this change is made with a § 481(a) adjustment. This adjustment may result in either a negative § 481(a) adjustment (a decrease in taxable income) or a positive § 481(a) adjustment (an increase in taxable income) and may be a different amount for regular tax, alternative minimum tax, and adjusted current earnings purposes. This § 481(a) adjustment equals the difference between the total amount of depreciation taken into account in computing taxable income for the property under the taxpayer's former method of accounting (including the amount attributable to any property described in section 2.01(1)(b) of this APPENDIX that is included in the taxpayer's Form 3115), and the total amount of depreciation allowable for the property under the taxpayer's new method of accounting (as determined under section 2.01(5) of this APPENDIX, and including the amount attributable to any property described in section 2.01(1)(b) of this APPENDIX that is included in the taxpayer's Form 3115), for open and closed years prior to the year of

change. However, the amount of the § 481(a) adjustment must be adjusted to account for the proper amount of the depreciation allowable that is required to be capitalized under any provision of the Code (for example, § 263A) at the beginning of the year of change.

(4) Basis adjustment. As of the beginning of the year of change, the basis of depreciable property to which section 2.01 of this APPENDIX applies must reflect the reductions required by § 1016(a)(2) for the depreciation allowable for the property (as determined under section 2.01(5) of this APPENDIX).

(5) Meaning of depreciation allowable.

(a) In general. Section 2.01(5) of this APPENDIX provides the amount of the depreciation allowable determined under § 56(a)(1), § 56(g)(4)(A), § 167, § 168, § 197, § 1400I, or § 1400L(c), or former § 168. This amount, however, may be limited by other provisions of the Code (for example, § 280F).

(b) Section 56(a)(1) property. The depreciation allowable for any taxable year for property for which depreciation is determined under § 56(a)(1) is determined by using the depreciation method, recovery period, and convention provided for under § 56(a)(1) that applies for the property's placed-in-service date.

(c) Section 56(g)(4)(A) property. The depreciation allowable for any taxable year for property for which depreciation is determined under § 56(g)(4)(A) is determined by using the depreciation method, recovery period or useful life, as applicable, and convention provided for under § 56(g)(4)(A) that applies for the property's placed-in-service date.

(d) Section 167 property. Generally, for any taxable year, the

depreciation allowable for property for which depreciation is determined under § 167, is determined either:

(i) under the depreciation method adopted by a taxpayer for the property; or

(ii) if that depreciation method does not result in a reasonable allowance for depreciation or a taxpayer has not adopted a depreciation method for the property, under the straight-line depreciation method.

For determining the estimated useful life and salvage value of the property, see § 1.167(a)-1(b) and (c), respectively.

The depreciation allowable for any taxable year for property subject to § 167(f) (regarding certain property excluded from § 197) is determined by using the depreciation method and useful life prescribed in § 167(f). If computer software is depreciated under § 167(f)(1) and is qualified property (as defined in § 168(k)(2) and § 1.168(k)-1T of the temporary Income Tax Regulations), 50-percent bonus depreciation property (as defined in § 168(k)(4) and § 1.168(k)-1T), or qualified New York Liberty Zone (Liberty Zone) property (as defined in § 1400L(b)(2) and § 1.1400L(b)-1T), the depreciation allowable for that computer software under § 167(f)(1) is also determined by taking into account the additional first year depreciation deduction provided by § 168(k) or § 1400L(b), as applicable, unless the taxpayer made a timely valid election not to deduct any additional first year depreciation for the computer software.

(e) Section 168 property. The depreciation allowable for any taxable year for property for which depreciation is determined under § 168, is determined as

follows:

(i) by using either:

(A) the general depreciation system in § 168(a); or

(B) the alternative depreciation system in § 168(g) if the property is required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) or other provisions of the Code (for example, property described in § 263A(e)(2)(A) or § 280F(b)(1)). Property required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) includes property in a class (as set out in § 168(e)) for which the taxpayer made a timely valid election under § 168(g)(7); and

(ii) if the property is qualified property, 50-percent bonus depreciation property, or Liberty Zone property, by taking into account the additional first year depreciation deduction provided by § 168(k) or § 1400L(b), as applicable, unless the taxpayer made a timely valid election not to deduct the additional first year depreciation (or made a deemed election not to deduct the additional first year depreciation; for further guidance, see Rev. Proc. 2002-33, 2002-1 C.B. 963, or Rev. Proc. 2003-50, 2003-29 I.R.B. 119) for the class of property (as defined in § 1.168(k)-1T(e)(2) or § 1.1400L(b)-1T(e)(2), as applicable) in which that property is included.

(f) Section 197 property. The depreciation allowable for any taxable year for an amortizable § 197 intangible (including any property for which a timely election under § 13261(g)(2) of the 1993 Act was made) is determined in accordance with § 1.197-2(f).

(g) Former § 168 property. The depreciation allowable for any taxable year for property subject to former § 168 is determined by using either:

(i) the accelerated method of cost recovery applicable to the property (for example, for 5-year property, the recovery method under former § 168(b)(1)); or

(ii) the straight-line method applicable to the property if the property is required to be depreciated under the straight-line method (for example, property described in former § 168(f)(12) or former § 280F(b)(2)) or if the taxpayer elected to determine the depreciation allowance under the optional straight-line percentage (for example, the straight-line method in former § 168(b)(3)).

(h) Qualified revitalization building. The depreciation allowable for any taxable year for any qualified revitalization building (as defined in § 1400I(b)(1)) for which the taxpayer has made a timely valid election under § 1400I(a) is determined as follows:

(i) if the taxpayer elected to deduct one-half of any qualified revitalization expenditures (as defined in § 1400I(b)(2)) chargeable to a capital account with respect to the qualified revitalization building for the taxable year in which the building is placed in service by the taxpayer, the depreciation allowable for the property's placed-in-service year is equal to one-half of the qualified revitalization expenditures for the property and the depreciation allowable for the remaining recovery period of the property is determined using the general depreciation system of § 168(a) or the alternative depreciation system of § 168(g), as applicable; or

(ii) if the taxpayer elected to amortize all of the qualified

revitalization expenditures chargeable to a capital account with respect to the qualified revitalization building ratably over the 120-month period beginning with the month in which the building is placed in service, the depreciation allowable is determined in accordance with this election.

(i) Qualified New York Liberty Zone leasehold improvement property. The depreciation allowable for any taxable year for qualified New York Liberty Zone leasehold improvement property (as defined in § 1400L(c)(2)) is determined by using the depreciation method and recovery period prescribed in § 1400L(c)."

SECTION 2. Section 2.02 of the APPENDIX of Rev. Proc. 2002-9 is deleted and replaced with the following:

".02 Permissible to permissible method of accounting for depreciation.

(1) Description of change. This change applies to a taxpayer that wants to change from a permissible method of accounting for depreciation under § 56(g)(4)(A)(iv) or § 167 to another permissible method of accounting for depreciation under § 56(g)(4)(A)(iv) or § 167. Pursuant to § 1.167(a)-7(a) and (c), a taxpayer may account for depreciable property either by treating each individual asset as an account or by combining two or more assets in a single account and, for each account, depreciation allowances are computed separately.

(2) Scope.

(a) Applicability. This change applies to any taxpayer wanting to make a change in method of accounting for depreciation specified in section 2.02(3) of this APPENDIX for the property in an account:

(i) for which the present and proposed methods of accounting for depreciation specified in section 2.02(3) of this APPENDIX are permissible methods for the property under § 56(g)(4)(A)(iv) or § 167; and

(ii) that is owned by the taxpayer at the beginning of the year of change.

(b) Certain scope limitations inapplicable. The scope limitations in sections 4.02(7) and 4.02(8) of this revenue procedure are not applicable to this change.

(c) Inapplicability. This change does not apply to:

(i) any taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 2.02 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(ii) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(iii) any property described in § 167(f) (regarding certain property excluded from § 197);

(iv) any property subject to § 167(g) (regarding property depreciated under the income forecast method);

(v) any property for which depreciation is determined under § 56(a)(1), § 56(g)(4)(A)(i), (ii), (iii), or (v), § 168, § 1400I, §1400L(b), or § 1400L(c), or § 168 prior to its amendment in 1986 (former § 168);

(vi) any property that the taxpayer elected under § 168(f)(1) or

former § 168(e)(2) to exclude from the application of, respectively, § 168 or former § 168;

(vii) any property for which depreciation is determined in accordance with § 1.167(a)-11 (regarding the Class Life Asset Depreciation Range System (ADR));

(viii) any depreciable property for which the taxpayer is changing the depreciation method pursuant to § 1.167(e)-1T(b) of the temporary Income Tax Regulations (change from declining-balance method to straight-line method), § 1.167(e)-1T(c) (certain changes for § 1245 property), or § 1.167(e)-1T(d) (certain changes for § 1250 property). These changes must be made prospectively and are not permitted under the cited regulations for property for which the depreciation is determined under § 168, § 1400I, § 1400L, or former § 168; or

(ix) any distributor commissions (as defined by section 2 of Rev. Proc. 2000-38, 2000-2 C.B. 310) for which the taxpayer is changing the useful life under the distribution fee period method or the useful life method (both described in Rev. Proc. 2000-38). A change in this useful life is corrected by adjustments in the applicable taxable year provided under § 1.446-1T(e)(2)(ii)(d)(3)(i).

(3) Changes covered. Section 2.02 of this APPENDIX only applies to the following changes in methods of accounting for depreciation:

(a) a change from the straight-line method to the sum-of-the-years-digits method, the sinking fund method, the unit-of-production method, or the declining-balance method using any proper percentage of the straight-line rate;

(b) a change from the declining-balance method using any percentage of the straight-line rate to the sum-of-the-years-digits method, the sinking fund method, or the declining-balance method using a different proper percentage of the straight-line rate;

(c) a change from the sum-of-the-years-digits method to the sinking fund method, the declining-balance method using any proper percentage of the straight-line rate, or the straight-line method;

(d) a change from the unit-of-production method to the straight-line method;

(e) a change from the sinking fund method to the straight-line method, the unit-of-production method, the sum-of-the-years-digits method, or the declining-balance method using any proper percentage of the straight-line rate;

(f) a change in the interest factor used in connection with a compound interest method or sinking fund method;

(g) a change in averaging convention as set forth in § 1.167(a)-10(b). However, as specifically provided in § 1.167(a)-10(b), in any taxable year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used (see Rev. Rul. 73-202, 1973-1 C.B. 81);

(h) a change from charging the depreciation reserve with costs of removal and crediting the depreciation reserve with salvage proceeds to deducting costs of removal as an expense and including salvage proceeds in taxable income as set forth in § 1.167(a)-8(e)(2). See Rev. Rul. 74-455, 1974-2 C.B. 63. This change, however, may be

made under this revenue procedure only if:

(i) the change is applied to all items in the account for which the change is being made; and

(ii) the removal costs are not required to be capitalized under any provision of the Code (for example, § 263(a), 263A, or 280B);

(i) a change from crediting the depreciation reserve with the salvage proceeds realized on normal retirement sales to computing and recognizing gains and losses on the sales (see Rev. Rul. 70-165, 1970-1 C.B. 43);

(j) a change from crediting ordinary income (including the combination method of crediting the lesser of estimated salvage value or actual salvage proceeds to the depreciation reserve, with any excess of salvage proceeds over estimated salvage value credited to ordinary income) with the salvage proceeds realized on normal retirement sales, to computing and recognizing gains and losses on the sales (see Rev. Rul. 70-166, 1970-1 C.B. 44);

(k) a change from item accounting for specific assets to multiple asset accounting for the same assets, or vice versa;

(l) a change from one type of multiple asset accounting (pooling) for specific assets to a different type of multiple asset accounting (pooling) for the same assets;

(m) a change from one method described in Rev. Proc. 2000-38 for amortizing distributor commissions (as defined by section 2 of Rev. Proc. 2000-38, 2000-2 C.B. 310) to another method described in Rev. Proc. 2000-38 for amortizing distributor

commissions; or

(n) a change from pooling to a single asset, or vice versa, for distributor commissions (as defined by section 2 of Rev. Proc. 2000-38, 2000-2 C.B. 310) for which the taxpayer is using the distribution fee period method or the useful life method (both described in Rev. Proc. 2000-38).

(4) Additional requirements. A taxpayer also must comply with the following:

(a) Basis for depreciation. At the beginning of the year of change, the basis for depreciation of property to which this change applies is the adjusted basis of the property as provided in § 1011 at the end of the taxable year immediately preceding the year of change (determined under the taxpayer's present method of accounting for depreciation). If applicable under the taxpayer's proposed method of accounting for depreciation, this adjusted basis is reduced by the estimated salvage value of the property (for example, a change to the straight-line method).

(b) Rate of depreciation. The rate of depreciation for property changed to:

(i) the straight-line or the sum-of-the-years-digits method of depreciation must be based on the remaining useful life of the property as of the beginning of the year of change; or

(ii) the declining-balance method of depreciation must be based on the useful life of the property measured from the placed-in-service date, and not the expected remaining life from the date the change becomes effective.

(c) Regulatory requirements. For changes in method of depreciation

to the sum-of-the-years-digits or declining-balance method, the property must meet the requirements of § 1.167(b)-0 or 1.167(c)-1, as appropriate.

(d) Public utility property. If any item of property is public utility property within the meaning of former § 167(l)(3)(A), the taxpayer must attach to the application a statement providing that the taxpayer agrees to the following additional terms and conditions:

(i) a normalization method of accounting within the meaning of former § 167(l)(3)(G) will be used for the public utility property subject to the application; and

(ii) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer will provide a copy of the completed application to any regulatory body having jurisdiction over the public utility property subject to the application.

(5) Section 481(a) adjustment. Because the adjusted basis of the property is not changed as a result of a method change made under section 2.02 of this APPENDIX, no items are being duplicated or omitted. Accordingly, no § 481(a) adjustment is required or necessary."

SECTION 3. Section 2B of the APPENDIX of Rev. Proc. 2002-9 is deleted and replaced with the following:

"SECTION 2B. COMPUTER SOFTWARE EXPENDITURES (§§ 162, 167, AND 197)

.01 Description of change. This change applies to a taxpayer that wants to change

its method of accounting for the costs of computer software to a method described in Rev. Proc. 2000-50, 2000-2 C.B. 601. Section 5 of Rev. Proc. 2000-50 describes the methods applicable to the costs of developing computer software. Section 6 of Rev. Proc. 2000-50 describes the method applicable to the costs of acquired computer software. Section 7 of Rev. Proc. 2000-50 describes the method applicable to leased or licensed computer software. If a taxpayer treats the costs of computer software in accordance with the applicable method described in Rev. Proc. 2000-50, the Service will not disturb the taxpayer's treatment of its costs of computer software.

.02 Scope. This change applies to all costs of computer software as defined in section 2 of Rev. Proc. 2000-50. However, this change does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in § 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as research and experimentation expenditures under § 174.

.03 Statement required. If a taxpayer is changing to the method described in section 5.01(2) of Rev. Proc. 2000-50, the taxpayer must attach to the application a statement providing the information required in section 8.02(2) of Rev. Proc. 2000-50."

SECTION 4. Section 2.05 of the APPENDIX of Rev. Proc. 2002-9 is added to read as follows:

".05 Impermissible to permissible method of accounting for depreciation or amortization for disposed depreciable or amortizable property.

(1) Description of change. This change applies to a taxpayer that wants to make the change in method of accounting for depreciation or amortization (depreciation)

provided under section 3 of Rev. Proc. 2004-11, 2004-3 I.R.B. __, for an item of depreciable or amortizable property that has been disposed of by the taxpayer. Section 3 of Rev. Proc. 2004-11 allows a taxpayer to make a change in method of accounting for depreciation for the disposed property if the taxpayer used an impermissible method of accounting for depreciation for the property under which the taxpayer did not take into account any depreciation allowance, or did take into account some depreciation but less than the depreciation allowable, in the year of change (as defined in section 2.05(3) of this APPENDIX) or any prior taxable year.

(2) Scope. This change applies to a taxpayer and an item of depreciable or amortizable property that are within the scope of section 3.01 of Rev. Proc. 2004-11, provided:

(a) the taxpayer files the original Form 3115 with the taxpayer's amended federal tax return for the year of change (as defined in section 2.05(3) of this APPENDIX) prior to the expiration of the period of limitation for assessment under § 6501(a) for the taxable year in which the item of depreciable or amortizable property was disposed of by the taxpayer; and

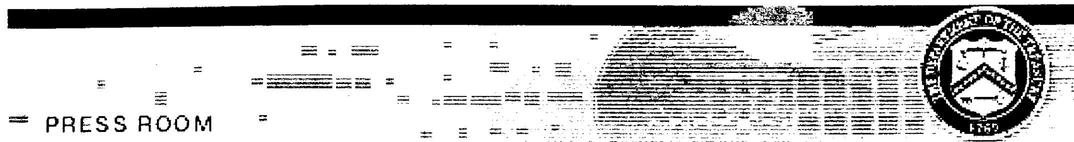
(b) the taxpayer's amended federal tax return for the year of change (as defined in section 2.05(3) of this APPENDIX) includes the adjustments to taxable income and any collateral adjustments to taxable income or tax liability (for example, adjustments to the amount or character of the gain or loss of the disposed depreciable or amortizable property) resulting from the change in method of accounting for depreciation made by the taxpayer under section 2.05 of this APPENDIX.

(3) Year of change. The year of change for this change is the taxable year in which the item of depreciable or amortizable property was disposed of by the taxpayer.

(4) Scope limitations inapplicable. The scope limitations in section 4.02 of this revenue procedure do not apply. If the taxpayer is under examination, before an appeals office, or before a federal court at the time that a copy of the Form 3115 is filed with the national office, the taxpayer must provide a copy of the Form 3115 to the examining agent, appeals officer, or counsel for the government, as appropriate, at the time the copy of the Form 3115 is filed with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent, appeals officer, or counsel for the government, as appropriate.

(5) Filing requirements. Notwithstanding section 6.02(3)(a) of this revenue procedure, a taxpayer making this change must attach the original Form 3115 to the taxpayer's timely filed amended federal tax return for the year of change and must file the required copy (with signature) of the Form 3115 with the national office no later than when the original Form 3115 is filed with the amended federal tax return for the year of change.

(6) Section 481(a) adjustment period. A taxpayer must take the § 481(a) adjustment into account in the year of change."



FROM THE OFFICE OF PUBLIC AFFAIRS

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December 30, 2003
js-1070

IRS Issues Notice for Regulations on Inversion Transaction Reporting

Today the IRS issued a notice providing additional guidance to taxpayers affected by the revised temporary regulations requiring corporations to notify the IRS and their shareholders when they move their headquarters offshore or are acquired by a foreign company. These revised regulations were published today in the Federal Register. The notice provides instructions for certain forms required under the regulations. In addition, the notice extends the January 5, 2004, reporting deadlines to January 12, 2004. The IRS also has issued Form 8806, which must be filed with the IRS by corporations covered by the regulations.

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Related Documents:

- Form: 8806
- Notice: 6043

Form **8806**
(December 2003)
Department of the Treasury
Internal Revenue Service

Information Return for Acquisition of Control or Substantial Change in Capital Structure

OMB No. 1545-1869

Part I — Reporting Corporation (see instructions)

1a Name of reporting corporation

b Address of reporting corporation

c EIN of reporting corporation

2a Name of reporting corporation's common parent, if any

b Address of reporting corporation's common parent

c EIN of reporting corporation's common parent

Part II — Acquiring Corporation (see instructions)

3a Name of acquiring corporation

b Address of acquiring corporation

c EIN of acquiring corporation

d Is the acquiring corporation a foreign corporation (as defined in section 7701(a)(5))? . . . . ☐ Yes ☐ No

e Is the acquiring corporation a dual resident corporation (see Regulations section 1.1503-2(c)(2))? . . . . . . ☐ Yes ☐ No

f Was the acquiring corporation newly formed prior to its involvement in the transaction? . . . . ☐ Yes ☐ No

4a Name of acquiring corporation's common parent, if any

b Address of acquiring corporation's common parent

c EIN of acquiring corporation's common parent

Part III — Information About Acquisition of Control or Substantial Change in Capital Structure

5a Date of transaction(s) that resulted in the acquisition of control or substantial change in capital structure

b Description of the transaction(s) ▶

6a Did the reporting corporation's shareholders receive any stock in exchange for their stock in the reporting corporation, for which the reporting corporation has reasonably determined that the shareholders **are not** required to recognize gain (if any) from the receipt of such stock? (If "No," go to line 7a) . . . . ☐ Yes ☐ No

b Fair market value of the stock received . . . . | 6b |

c Description of the stock received ▶

7a Amount of cash received by the reporting corporation's shareholders in exchange for their stock . . . | 7a |

b Fair market value of property, other than stock, received by the reporting corporation's shareholders . . | 7b |

c Did the reporting corporation's shareholders receive any stock, other than stock described on line 6c above, in exchange for their stock in the reporting corporation, for which the reporting corporation has reasonably determined that its shareholders **would** be required to recognize gain (if any) from the receipt of such stock? (If "No," go to line 7e.) . . . ☐ Yes ☐ No

d Fair market value of the stock received . . . . | 7d |

e Total cash and property. Add lines 7a, 7b, and 7d . . . . | 7e |

f Description of the stock ▶

Sign Here

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer ▶ Date

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
		Phone no. ( )	

Part IV — Consent Election

8 Does the reporting corporation consent to the publication of its name and address, date of transaction(s), description of shares affected by the transaction(s) and the amount of cash and fair market value of any property provided to each class of shareholders in exchange for a share, on an IRS website and/or in an IRS publication, as described in Temporary Regulations section 1.6043-4T(a)(2), to assist brokers to satisfy their reporting obligations under Temporary Regulations section 1.6045-3T? . . . . ☐ Yes ☐ No

Under penalties of perjury, I declare that I am an officer of the above named corporation and that I am authorized to give consent on behalf of the above named corporation for the IRS to publish the information necessary to enable brokers to satisfy their reporting obligations under Temporary Regulations section 1.6045-3T.

Sign Here ▶ Signature of officer | Date | Title

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

A reporting corporation must file **Form 8806,** Information Return for Acquisition of Control or Substantial Change in Capital Structure, to report an acquisition of control or a substantial change in the capital structure of a domestic corporation.

Definitions

Acquisition of Control of a Corporation

Generally, an acquisition of control of a corporation (first corporation) occurs if, in a transaction or series of related transactions, either:

- Stock representing control of the first corporation is distributed by a second corporation to shareholders of the second corporation and the fair market value of such stock on the date of distribution is $100 million or more or
- Before an acquisition of stock of the first corporation (directly or indirectly) by a second corporation, the second corporation does not have control of the first corporation; after the acquisition, the second corporation has control of the first corporation; the fair market value of the stock acquired in the transaction and in any related transactions as of the date or dates on which the stock was acquired is $100 million or more; and the shareholders of the first corporation (determined without applying the constructive ownership rule of section 318(a)) receive cash, stock, or other property pursuant to the aquisition.

Control. Control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock.

Constructive ownership. Generally, the constructive ownership rules of section 318(a) (except for section 318(a)(4), providing for constructive ownership through an option to acquire stock), modified as provided in section 304(c)(3)(B), apply for determining whether there has been an acquisition of control. The determination of whether there has been an acquisition of control will be made without regard to whether the person or persons from whom control was acquired retain indirect control of the first corporation under section 318(a). Section 318(a) will not cause a second corporation to be treated as owning, before an acquisition of stock in a first corporation (directly or indirectly) by the second corporation, any stock that is acquired in the first corporation.

Corporation includes group. If two or more corporations act according to a plan or arrangement with respect to the acquisition of stock, they will be treated as one corporation.

Section 338 election. An acquisition of stock of a corporation with respect to which an election under section 338 is made is treated as an acquisition of stock (and not as an acquisition of the assets of the corporation).

Substantial Change in Capital Structure of a Corporation

A corporation has a substantial change in capital structure if it has a change in capital structure and the amount of any cash and the fair market value of any other property (including the value of any stock) provided to the shareholders of such corporation pursuant to the change in capital structure, as of the date or dates on which the cash or other property is provided, is $100 million or more. Generally, a corporation has a change in capital structure if the corporation in a transaction or series of transactions:

- Undergoes a recapitalization with respect to its stock;
- Redeems its stock (including deemed redemptions);
- Merges, consolidates, or otherwise combines with another corporation or transfers all or substantially all of its assets to one or more corporations;
- Transfers all or part of its assets to another corporation in a Title 11 or similar case and, in pursuance of the plan, distributes stock or securities of that corporation; or
- Changes its identity, form, or place of organization.

Receipt of property. A shareholder is treated as receiving property (or as having property provided to it) related to an aquisition of control or a substantial change in capital structure if a liability of the shareholder is assumed in the transaction and, as a result of the transaction, an amount is realized by the shareholder from the sale or exchange of stock.

Reporting Corporation

A reporting corporation is a corporation whose stock was acquired in an acquisition of control or that had a substantial change in its capital structure.

Acquiring Corporation

The acquiring corporation is any corporation that acquired control of the reporting corporation or received assets from the reporting corporation pursuant to a substantial change in capital structure of the reporting corporation.

Who Must File

A reporting corporation is required to file Form 8806 if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a) to the transaction.

If the reporting corporation transfers all or substantially all of its assets to an acquiring corporation in a transaction that constitutes a substantial change in the capital structure of the reporting corporation and the reporting corporation does not file Form 8806, then the acquiring corporation must file Form 8806. If neither corporation files Form 8806, both corporations are jointly and severally liable for any applicable penalties. See **Penalties for Failure To File** below.

Corporations Not Required To File

Do not file Form 8806:

- For transactions that were properly reported under section 6043(a); or
- If the reporting corporation reasonably determines that all of its shareholders who receive cash, stock, or other property related to the acquisition of control or substantial change in capital structure are exempt recipients under Temporary Regulations section 1.6043-4T(b)(6).

When To File

File Form 8806, within 45 days after the transaction, or if earlier by January 5th of the calendar year following the year in which the acquisition of control or substantial change in capital structure occured.

If an acquisition of control or a substantial change in capital structure of a corporation occurs after December 31, 2002, and before December 30, 2003, Form 8806 must be filed on or before January 5, 2004.

Where To File

Mail Form 8806 to:

Internal Revenue Service
Large and Midsize Business Division
Attention: PFTS
1111 Constitution Ave., NW
Washington, DC 20224

Penalties for Failure To File

Caution: *Form 8806 and **all** Forms 1099-CAP, Changes in Corporate Control and Capital Structure, required to be filed under Temporary Regulations sections 1.6043-4T(a) and (b) will be considered as one return for purposes of the failure to file penalty under section 6652(l).*

If a correct Form 8806 is not filed by the due date of the corporation's income tax return, including extensions, it may be penalized $500 for each day the

return is late, up to a maximum of $100,000. The penalty will not be imposed if the corporation can show that the failure to file on time was due to reasonable cause. Corporations that file late must attach a statement explaining the reasonable cause. Additional penalties may apply under sections 7203, 7206, and 7207.

Note: *Failure to file also includes the requirement to file on magnetic media as required by section 6011(e) and Regulations section 1.6011-2.*

Information Returns Regarding Shareholders

A corporation required to file Form 8806 also must file Form 1099-CAP for certain shareholders of record who receive cash or other property (including stock) in exchange for their stock in the reporting corporation due to the acquisition of control or the substantial change in capital structure. See Form 1099-CAP for more information.

Specific Instructions

Employer identification number (EIN). An EIN must be included for each corporation identified. An EIN is not required if the corporation does not have, and is not otherwise required to have, an EIN.

Common parent of the reporting corporation. If the reporting corporation was a subsidiary member of a consolidated group immediately prior to the reportable transaction, complete lines 2a and 2b.

Common parent of the acquiring corporation. If the acquiring corporation was a subsidiary member of a consolidated group at the time of the change in control or substantial change in capital structure, complete lines 4a and 4b.

Part IV–Consent Election

A reporting corporation may elect to consent to the IRS publication (on the IRS website and/or an IRS publication) of information included on this form, to be limited to the name and address of the corporation, the date of the transaction, a description of the shares affected by the transaction, and the amount of cash and the fair market value of any property (as reflected on line 7e) provided to each class of shareholders in exchange for a share. See Temporary Regulations section 1.6043-4T(a)(2).

Corporations that elect to consent to such publication are not required to file Form 1099-CAP with respect to shareholders that are clearing organizations, or to furnish Form 1099-CAP to such organizations. See Temporary Regulations section 1.6043-4T(b)(1) and (4).

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this tax form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping . . .	6 hr., 42 min.
Learning about the law or the form . . .	2 hr., 10 min.
Preparing and sending the form to the IRS .	2 hr., 23 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send this form to this address. Instead see **Where To File** on page 2.

Part III – Administrative, Procedural, and Miscellaneous

Notice –

SECTION 1. Purpose

This Notice announces the extension of certain 2004 deadlines under revised §§ 1.6043-4T and 1.6045-3T of the Income Tax Regulations for filing Form 8806 and furnishing Form 1099-CAP to clearing organizations. This Notice also provides information to filers of Forms 1099-CAP and 1099-B to assist in complying with the reporting requirements set forth in revised §§ 1.6043-4T and 1.6045-3T. The 2003 Forms 1099-CAP and 1099-B, and their instructions, do not reflect the provisions of the revised temporary regulations.

SECTION 2. Background

On December 30, 2003, the Internal Revenue Service (Service) issued temporary regulations under sections 6043(c) and 6045 of the Internal Revenue Code (TD 9101, ___ FR___). These regulations, which revise temporary regulations issued on November 18, 2002 (TD 9022, 67 FR 69468), require information reporting if a domestic corporation undergoes an acquisition of control or a substantial change in capital structure after December 31, 2002, if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a) of the Internal Revenue Code (Code). Pursuant to the revised regulations, a corporation must file Form 8806, "Information Return for Acquisition of Control or

Substantial Change in Capital Structure," reporting and describing the acquisition of control or substantial change in capital structure. In addition, the revised regulations require the corporation to file Form 1099-CAP, "Changes in Corporate Control and Capital Structure," with the Service with respect to each of its shareholders that is not an exempt recipient, and to furnish Form 1099-CAP to each such shareholder. The regulations also require a broker that holds stock on behalf of a customer in the corporation that the broker knows or has reason to know has engaged in a transaction described in these regulations to file Form 1099-B, "Proceeds from Broker and Barter Exchange Transactions," with the Service with respect to its customer, and to furnish a copy of the Form 1099-B to the customer.

SECTION 3. Extension of Deadlines

Section 6081 of the Code provides that the Secretary may grant a reasonable extension of time for filing any return, declaration, statement, or other document required by the Code or by regulations thereunder. Under the authority of section 6081, the Service is extending the deadlines set forth in revised §§ 1.6043-4T and 1.6045-3T for filing Forms 8806 with the Service and furnishing Forms 1099-CAP to clearing organizations for transactions occurring in calendar year 2003. Forms 8806 otherwise required to be filed with the Service by January 5, 2004, must be filed by January 12, 2004. Forms 1099-CAP otherwise required to be furnished to clearing organizations by January 5, 2004, must be furnished by January 12, 2004. This extension does not apply to any other deadline.

SECTION 4. Information for Filers of Form 1099-CAP

Under revised § 1.6043-4T(b), a reporting corporation must file Form 1099-CAP with respect to its shareholders who are not exempt recipients. The list of exempt recipients is set forth in § 1.6043-4T(b)(5), and includes brokers. Clearing organizations are not exempt recipients under the revised regulations. Therefore, corporations must file Form 1099-CAP with respect to shares held by a clearing organization, and furnish a copy of the form to the clearing organization. Pursuant to § 1.6043-4T(b)(4), Form 1099-CAP must be furnished to clearing organizations by January 5th of the year following the calendar year in which the transaction took place. Pursuant to Section 3 of this Notice, Forms 1099-CAP otherwise due on January 5, 2004, must be furnished to clearing organizations no later than January 12, 2004. Taxpayers, however, are encouraged to comply as soon as possible prior to January 12, 2004.

The Depository Trust Company (DTC) is a clearing organization which holds a large percentage of publicly issued securities, and is likely to receive Forms 1099-CAP pursuant to the provisions of § 1.6043-4T(b). In anticipation of receiving such forms, DTC has established a specific mailing address. DTC requests that Forms 1099-CAP be delivered via express mail or other overnight service to:

Tax Information Reporting Services
Depository Trust & Clearing Corporation
55 Water Street – 25th Floor
New York, NY 10041
(212) 855-4703

The envelope should be marked with the words:

TIME CRITICAL TAX INFORMATION FORM 1099-CAP

DTC will also accept Form 1099-CAP electronically. Forms should be emailed to:

1099CAP@dtcc.com in Adobe Acrobat PDF file format

Furnishing Forms 1099 to payees electronically is permitted pursuant to section 401 of the Job Creation and Worker Assistance Act of 2002, if the rules set forth in § 31.6051-1T(j) are followed.

SECTION 5. Information for Filers of Form 1099-B

Pursuant to revised § 1.6045-3T(a), a broker that holds shares on behalf of a customer in a corporation that the broker knows or has reason to know has engaged in a transaction under §1.6043-4T(c) or (d) must file an information return with respect to the customer, unless the customer is an exempt recipient, and furnish a copy of the information return to the customer. Revised § 1.6045-3T(c) provides that the broker must use Form 1099-B, along with transmittal Form 1096, for this information reporting requirement. With respect to transactions in 2003, the broker may elect to use Form 1099-CAP in lieu of Form 1099-B.

In completing Form 1099-B, brokers should aggregate all proceeds (cash, stock, and other property) provided to the customer in Box 2 (Stocks, bonds, etc.). Brokers should use Box 5 (Description) to report the name and address of the corporation which engaged in the transaction and the number and class of shares exchanged by the customers (as required by § 1.6045-3T(d)(2) and (3)).

SECTION 6. DRAFTING INFORMATION

For further information regarding this Notice, contact Nancy Rose of the Office of the Associate Chief Counsel (Procedure & Administration), Administrative Provisions and Judicial Practice Division, at (202) 622-4910 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 30, 2003
js-1071

Air Transportation Stabilization Board Issues Federal Guarantee on Behalf of World Airways, Inc.

The Air Transportation Stabilization Board today announced that World Airways, Inc. has closed on a $30 million loan. The loan is backed by a $27 million Federal guarantee issued under the Air Transportation Safety and System Stabilization Act and implementing regulations promulgated by the Office of Management and Budget.

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FROM THE OFFICE OF PUBLIC AFFAIRS

December 31, 2003
2003-12-31-9-42-14-18557

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $87,246 million as of the end of that week, compared to $86,924 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*

	December 19, 2003			December 26, 2003		
TOTAL		86,924			87,246	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	8,281	14,573	22,853	8,329	14,676	23,005
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	13,518	2,927	16,445	13,590	2,948	16,538
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			24,189			24,240
3. Special Drawing Rights (SDRs) [2]			12,394			12,420
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	December 19, 2003			December 26, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0

2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:

2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	December 19, 2003			December 26, 2003		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be subject to revision. IMF data for the prior week are final.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 31, 2003
js-1073

Treasury and IRS Issue Guidance On Roth IRA Abuses

Today, the Treasury Department and the IRS issued guidance to shut down abuses involving indirect contributions to Roth IRAs. The notice includes that these abuses satisfy the list-keeping and registration requirements for tax shelter arrangements that are "listed transactions." The guidance addresses situations in which value is shifted into an individual's Roth IRA through transactions involving entities owned by the individual.

"The notice illustrates that a contribution to an IRA through a transaction that disguises the value of the contribution may disqualify the IRA," stated Treasury Assistant Secretary for Tax Policy Pam Olson. For example, a business owned by the individual could sell its receivables for less than fair value to a shell corporation owned by the individual's Roth IRA. This scheme artificially shifts taxable income away from the individual's business into the shelter of the Roth IRA structure. "In effect, this is a disguised contribution to the Roth IRA and the notice makes clear that it will be treated as such," Olson concluded.

"For many people, the Roth IRA is an important retirement savings tool," said IRS Commissioner Mark W. Everson. "We are concerned that some would try to abuse this savings vehicle in an attempt to skirt their tax responsibilities."

The notice applies to any arrangement that has the effect of transferring value to the Roth IRA corporation comparable to a contribution to the Roth IRA.

The notice states that, the IRS also may assert that these are "prohibited transactions" under the Code rules that disqualify the IRA or impose an excise tax on transactions between an IRA and the individual for whom the IRA is maintained or other disqualified persons with respect to the IRA. The notice states that this transaction, and any transaction that is substantially similar, are identified as "listed transactions" that are subject to disclosure and to list-keeping and registration requirements.

The text of the notice is attached.

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Related Documents:

- Roth IRA Abuses Notice 2004-8

Part III – Administrative, Procedural and Miscellaneous

Abusive Roth IRA Transactions

Notice 2004-8

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, that taxpayers are using to avoid the limitations on contributions to Roth IRAs. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, as well as substantially similar transactions, 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. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

Background

Section 408A was added to the Internal Revenue Code by section 302 of the Taxpayer Relief Act of 1997, Pub. L. 105-34, 105th Cong., 1st Sess. 40 (1997). This section created Roth IRAs as a new type of nondeductible individual retirement arrangement (IRA). The maximum annual contribution to Roth IRAs is the same maximum amount that would be allowable as a deduction under § 219 with respect to the individual for the taxable year over the aggregate amount of contributions for that taxable year to all other IRAs. Neither the contributions to a Roth IRA nor the earnings on those contributions are subject to tax on distribution, if distributed as a qualified distribution described in § 408A(d)(2).

A contribution to a Roth IRA above the statutory limits generates a 6-percent excise tax described in § 4973. The excise tax is imposed each year until the excess contribution is eliminated.

Facts

In general, these transactions involve the following parties: (1) an individual (the Taxpayer) who owns a pre-existing business such as a corporation or a sole proprietorship (the Business), (2) a Roth IRA within the meaning of § 408A that is maintained for the Taxpayer, and (3) a corporation (the Roth IRA Corporation), substantially all the shares of which are owned or acquired by the Roth IRA. The Business and the Roth IRA Corporation enter into transactions as described below. The acquisition of shares, the transactions or

both are not fairly valued and thus have the effect of shifting value into the Roth IRA.

Examples include transactions in which the Roth IRA Corporation acquires property, such as accounts receivable, from the Business for less than fair market value, contributions of property, including intangible property, by a person other than the Roth IRA, without a commensurate receipt of stock ownership, or any other arrangement between the Roth IRA Corporation and the Taxpayer, a related party described in § 267(b) or 707(b), or the Business that has the effect of transferring value to the Roth IRA Corporation comparable to a contribution to the Roth IRA.

Analysis

The transactions described in this notice have been designed to avoid the statutory limits on contributions to a Roth IRA contained in § 408A. Because the Taxpayer controls the Business and is the beneficial owner of substantially all of the Roth IRA Corporation, the Taxpayer is in the position to shift value from the Business to the Roth IRA Corporation. The Service intends to challenge the purported tax benefits claimed for these arrangements on a number of grounds.

In challenging the purported tax benefits, the Service will, in appropriate cases, assert that the substance of the transaction is that the amount of the value shifted from the Business to the Roth IRA Corporation is a payment to the Taxpayer, followed by a contribution by the Taxpayer to the Roth IRA and a contribution by the Roth IRA to the Roth IRA Corporation. In such cases, the Service will deny or reduce the deduction to the Business; may require the Business, if the Business is a corporation, to recognize gain on the transfer under § 311(b); and may require inclusion of the payment in the income of the Taxpayer (for example, as a taxable dividend if the Business is a C corporation). See Sammons v. United States, 433 F.2d 728 (5th Cir. 1970); Worcester v. Commissioner, 370 F.2d 713 (1st Cir. 1966).

Depending on the facts of the specific case, the Service may apply § 482 to allocate income from the Roth IRA Corporation to the Taxpayer, Business, or other entities under the control of the Taxpayer. Section 482 provides the Secretary with authority to allocate gross income, deductions, credits or allowances among persons owned or controlled directly or indirectly by the same interests, if such allocation is necessary to prevent evasion of taxes or clearly to reflect income. The § 482 regulations provide that the standard to be applied is that of a person dealing at arm's length with an uncontrolled person. See generally § 1.482-1(b) of the Income Tax Regulations. To the extent that the consideration paid or received in transactions between the Business and the Roth IRA Corporation is not in accordance with the arm's length standard, the Service may apply § 482 as necessary to prevent evasion of taxes or clearly to reflect income. In the event of a § 482 allocation between the Roth IRA

Corporation and the Business or other parties, correlative allocations and other conforming adjustments would be made pursuant to § 1.482-1(g). Also see, Rev. Rul. 78-83, 1978-1 C.B. 79.

In addition to any other tax consequences that may be present, the amount treated as a contribution as described above is subject to the excise tax described in § 4973 to the extent that it is an excess contribution within the meaning of § 4973(f). This is an annual tax that is imposed until the excess amount is eliminated.

Moreover, under § 408(e)(2)(A), the Service may take the position in appropriate cases that the transaction gives rise to one or more prohibited transactions between a Roth IRA and a disqualified person described in § 4975(e)(2). For example, the Department of Labor[1] has advised the Service that, to the extent that the Roth IRA Corporation constitutes a plan asset under the Department of Labor's plan asset regulation (29 C.F.R. § 2510.3-101), the provision of services by the Roth IRA Corporation to the Taxpayer's Business (which is a disqualified person with respect to the Roth IRA under § 4975(e)(2)) would constitute a prohibited transaction under § 4975(c)(1)(C).[2] Further, the Department of Labor has advised the Service that, if a transaction between a disqualified person and the Roth IRA would be a prohibited transaction, then a transaction between that disqualified person and the Roth IRA Corporation would be a prohibited transaction if the Roth IRA may, by itself, require the Roth IRA Corporation to enter into the transaction.[3]

Listed Transactions

The following transactions are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective December 31, 2003, the date this document is released to the public: arrangements in which an individual, related persons described in § 267(b) or 707(b), or a business controlled by such individual or related persons, engage in one or more transactions with a corporation, including contributions of property to such corporation, substantially all the shares of which are owned by one or more Roth IRAs maintained for the benefit of the individual, related persons

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[1] Under section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of Labor has interpretive jurisdiction over § 4975 of the Internal Revenue Code.

[2] For the Roth IRA Corporation to be considered as holding plan assets under the Department of Labor's plan asset regulation, the Roth IRA's investment in the Roth IRA Corporation must be an equity interest, the Roth IRA Corporation's securities must not be publicly-offered securities, and the Roth IRA's investment in the Roth IRA Corporation must be significant. 29 C.F.R. §§ 2510.3-101(a)(2), 2510.3-101(b)(1), 2510.3-101(b)(2), and 2510.3-101(f). Although the Roth IRA Corporation would not be treated as holding plan assets if the Roth IRA Corporation constituted an operating company within the meaning of 29 C.F.R. § 2510.3-101(c), given the context of the examples described in this notice, it is unlikely that the Roth IRA Corporation would qualify as an operating company.

[3] See 29 C.F.R. § 2509.75-2(c).

described in § 267(b)(1), or both. The transactions are listed transactions with respect to the individuals for whom the Roth IRAs are maintained, the business (if not a sole proprietorship) that is a party to the transaction, and the corporation substantially all the shares of which are owned by the Roth IRAs. Independent of their classification as "listed transactions," these transactions may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§§ 301.6111-1T and 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1).

Substantially similar transactions include transactions that attempt to use a single structure with the intent of achieving the same or substantially same tax effect for multiple taxpayers. For example, if the Roth IRA Corporation is owned by multiple taxpayers' Roth IRAs, a substantially similar transaction occurs whenever that Roth IRA Corporation enters into a transaction with a business of any of the taxpayers if distributions from the Roth IRA Corporation are made to that taxpayer's Roth IRA based on the purported business transactions done with that taxpayer's business or otherwise based on the value shifted from that taxpayer's business to the Roth IRA Corporation.

Persons required to register these tax shelters under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have fail to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662, and as applicable, persons who participate in the reporting of this transaction or substantially similar transactions, including the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

Drafting Information

The principal author of this notice is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. However, other personnel from the Service and Treasury participated in its development. Mr. Rubin may be reached at (202) 283-9888 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 31, 2003
js-1074

Fact Sheet: Tax Accomplishments In 2003

This past May, the President signed the Jobs and Growth Tax Relief Reconciliation Act of 2003. The Act provides a boost to the economy this year, and provides a sound basis for promoting economic growth in the future. The Jobs and Growth Tax Relief Act had an immediate impact on the economy, with 3rd Q GDP growth reaching 8.2%. The Jobs and Growth Tax Relief Act will continue to buoy the economy as taxpayers see increased tax refunds come April 15th from the increased child credit, reduced marriage penalty, and reduced rates, and as businesses invest to take advantage of the increased expensing and bonus depreciation.

- Taxpayers with children received an immediate boost from rebate checks of $400 per eligible child sent out in July and August.
- Because of lower tax rates and less income tax withholding, workers saw higher take-home pay in their paychecks starting in July of this year.
- Married couples benefit from reduction in the marriage penalty from expansion of the fifteen percent rate bracket and increase in the standard deduction for joint filers.
- Families benefit from increased child tax credits.
- Investors benefit from the lower tax rates on dividends and capital gains. These lower rates were a positive step toward the President's goal of reducing the double tax on dividends, and will help promote capital formation and an ownership society.
- Small businesses are benefiting from a four-fold increase in the amount of new investment they can deduct in one year, from $25,000 to $100,000.
- All businesses are benefiting from the increase in bonus depreciation from 30 to 50 percent, as well as its extension through 2004 (2005 for longer-lived property). This change addressed what had been a weak spot in the economic recovery – low corporate investment.

We see the benefits of these tax cuts in today's economy and in the outlook for next year:

- Business investment grew at an even faster rate, up 13 percent on an annual basis.
- The outlook for next year is excellent: The most recent survey of business economists showed that they expect growth next year to be a very healthy 4 ½ percent.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 created health savings accounts (HSAs) to give individuals more choices, maintain the doctor-patient relationship, promote cost consciousness, and potentially reduce the growth of health care costs.

- Taxpayers can make tax–deductible contributions to an HSA if the individual is covered by high-deductible health insurance. Earnings on, and withdrawals from, the account are tax free if used to cover qualified medical expenses.

- HSAs are an innovative approach to give more choice to individuals and help give them more control over their medical care.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 31, 2003
js-1075

Tax Information Exchange Agreement Between The United States And The Bahamas Enters Into Force

The Treasury Department announced today that the United States and The Bahamas have exchanged diplomatic notes that bring into force the tax information exchange agreement between the two countries that was signed in Washington, DC in 2002. The Agreement enters into force on December 31, 2003.

The Agreement takes effect on January 1, 2004, with respect to requests for information made in connection with criminal tax matters, and on January 1, 2006, with respect to requests for information made in connection with civil tax matters. Once the Agreement is effective with respect to requests for information made in connection with civil tax matters, it will be consistent with the standards for an exchange of information agreement described in the Internal Revenue Code. The Code generally allows U.S. taxpayers to claim a tax deduction for expenses associated with a convention held in certain beneficiary countries with tax information exchange agreements with the United States to the same extent as a convention held in the United States.

Beginning on January 1, 2006, The Bahamas will be considered part of the "North American area" for purposes of determining whether U.S. taxpayers may deduct expenses incurred in attending conventions, business meetings and seminars in The Bahamas. Convention expenses that are incurred by U.S. taxpayers for meetings in geographical areas considered part of the North American area and that otherwise are deductible as ordinary and necessary business expenses are allowed as deductions without regard to the additional limitations applicable to deductions for expenses associated with foreign conventions. A list of geographical areas that currently are included in the North American area for purposes of these convention expense deduction rules is provided in Revenue Ruling 2003-109.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 31, 2003
JS-1076

Treasury Eases Restrictions To Assist Humanitarian Relief Activities For Earthquake Victims In Iran

President Bush directed Treasury Secretary Snow and State Department Secretary Powell to ease restrictions to assist humanitarian relief activities for earthquake victims in Iran. Today the Treasury Department announced that the Office of Foreign Assets Control ("OFAC") is taking extraordinary steps along with the Department of State and USAID to expedite disaster relief and humanitarian aid operations in response to the devastating earthquake in Bam, Iran.

"We understand the need to speed up the process allowing nongovernmental organizations to help the people devastated by the earthquake in Iran. Getting aid to those so greatly affected by this devastating earthquake is a top priority," stated Treasury Secretary John Snow.

The following authorizations and expedited procedures are being instituted today:

- Issuance of a General License (not requiring any application to, or further specific authorization from OFAC) authorizing cash donations to nongovernmental organizations to be used for disaster relief and humanitarian aid operations in response to the earthquake;
- Authorization to carry out humanitarian relief activities in Iran of any nongovernmental organization registered with, funded by, or under contract with the State Department/USAID;
- In response to applications, immediate issuance of specific licenses to nongovernmental organizations not covered above previously authorized to engage in humanitarian activities in Afghanistan or countries currently subject to economic sanctions to carry out humanitarian relief activities in Iran;
- Expedited issuance of specific licenses to nongovernmental organizations not previously authorized by OFAC to engage in humanitarian activities in countries subject to economic sanctions.

The OFAC Licensing Division will remain open tomorrow, January 1, 2004, to ensure that licenses are issued as quickly as possible under the above criteria and that telephone inquiries are answered to address any questions or concerns that may arise.

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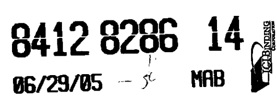

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