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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 2, 2004
JS-1818

Statement by Treasury Secretary John Snow
August 2, 2004

Our nation's financial markets, financial institutions and financial sector continue to operate normally. I applaud the financial services industry for remaining open for business in the face of yesterday's reporting. The extraordinary commitment of the men and women who make our financial systems work is invaluable; their work demonstrates the resiliency and strength of our financial system.

The Treasury Department has been in close, continual and ongoing cooperation with the Department of Homeland Security, other federal, state and local financial regulators, the international financial institutions, and the private sector to strengthen and protect our critical financial infrastructure.

Working together we have taken numerous steps including: improved communications systems and protocols between and among financial regulators and critical financial institutions, coordinated identification of potential vulnerabilities in the financial services sector and efforts to mitigate these vulnerabilities, joined with financial regulators and private sector financial services groups to present security seminars to financial business leaders in major cities all across the nation, issued guidance on business continuity planning, and conducted numerous drills and exercises to test backup systems and prepare financial professionals.

People around the world rightly have confidence in the U.S. financial markets. While we must always remain vigilant against terror, we will not be intimidated and prevented from enjoying our lives and exercising our freedoms. Our resolve is indivisible – and unyielding. In the war on terrorist financing we have successfully disrupted and, in some cases, dismantled the financial infrastructure of terrorist operations. Working in cooperation with the international community, we have frozen more than $140 million in terrorist-related assets, designated 383 individuals and entities as terrorist supporters, apprehended or disrupted key terrorist facilitators and deterred donors from supporting al Qaeda and other like-minded terrorist groups. In addition, the Administration has collaborated with Congress to develop a new Treasury Department structure - the Office of Terrorism and Financial Intelligence (TFI) - to strengthen our efforts to fight terrorist financing. America is safer today because we have made it harder and costlier for al Qaeda and other terrorist groups to raise and move money around the world.

The international financial institutions -- the International Monetary Fund and the World Bank Group in particular -- have also taken extraordinary measures to protect against the threat of a terrorist attack. The U.S. Treasury has worked closely with these institutions to help ensure that they will continue to make their vital contributions to the global economy. We applaud their dedication as they continue to operate during the raised threat level.

Federal regulators and law enforcement officials will continue to work closely with financial market participants to quickly respond to any potential market disruptions. The key financial coordinating groups which work with the financial markets in our efforts to secure the financial infrastructure will continue their activity. Among those are the President's Working Group on Financial Markets (PWGFM) chaired by Treasury whose members include the heads of four agencies: Treasury, Federal Reserve Board, SEC and CFTC; the Financial and Banking Information Infrastructure Committee (FBIIC) which is chaired by the Treasury and comprised of federal and state financial regulators; the Financial Services Sector Coordinating Council (FSSCC)--the chairman of which is appointed by the Treasury Secretary; and the Financial Services Information and Analysis Center (FS-ISAC). All are in

close cooperation and coordination with each other, the Department of Homeland Security, other key agencies and the private sector.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 2, 2004
JS-1819

Treasury and IRS Finalize Regulations for Incentive Stock Options

Today, the Treasury Department and the IRS issued final regulations on incentive stock options ("ISOs"). These regulations finalize, with modest changes, regulations proposed in 2003.

ISOs provide employees with the ability to acquire employer stock without realizing income when the option is exercised. If the employee holds the stock for a required period, any gains on the sale of the stock are capital gains. The exercise price for an ISO must be no less than the fair market value of the underlying stock on the date the ISO is granted. An ISO plan must be approved by shareholders, and the amount of ISOs that can be granted to an employee is limited. If the employee meets the holding period requirements for capital gains treatment on the sale of the stock, the employer is not entitled to a deduction with respect to the ISO.

The final regulations include a number of minor changes from the proposed regulations, including revisions to the rules regarding maximum aggregate number of shares in an ISO plan, substitution and assumption of ISOs and modification of ISOs.

The final regulations generally will be effective on the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring at least 6 months after the publication of the final regulations.

REPORTS

- The text of the final regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 14a

[TD 9144]

RIN 1545-BA75

Statutory Options

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to statutory options. These final regulations affect certain taxpayers who participate in the transfer of stock pursuant to the exercise of incentive stock options and the exercise of options granted pursuant to an employee stock purchase plan (statutory options). These regulations provide guidance to assist these taxpayers in complying with the law in addition to clarifying rules regarding statutory options.

DATES: Effective Date: These regulations are effective on August 3, 2004. For rules concerning reliance and transition period, see §§1.421-1(j)(2), 1.421-2(f)(2), 1.422-5(f)(2), and 1.424-1(g)(2).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, please contact Erinn Madden at (202) 622-6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations (see §1.6039-1) has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-0820. Responses to this collection of information are required to assist taxpayers with the completion of their income tax returns for the taxable year in which a dispositio of statutory option stock occurs.

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 contrc number assigned by the Office of Management and Budget.

The estimated annual burden per respondent varies from 15 minutes to 25 minutes, depending on individual circumstances, with an estimated average of 20 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Report Clearance Officer, SE:W:CAR:MP:T:T:SP Washington, DC 20224, and 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.

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

Background

This document contains amendments to 26 CFR part 1 under sections 421, 422, and, 424 of the Internal Revenue Code (Code). Changes to the applicable tax law concerning section 421 were made by sections 11801 and 11821 of the Omnibus Budget Reconciliation Act of 1990 (OBRA 90), Public Law 101-508 (104 Stat. 1388). Changes to the applicable tax law concerning section 424 were made by section 1003 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Public Law 100-647 (102 Stat. 3342), sections 11801 and 11821 of OMBRA 90, which included re-designating section 425 as section 424 of the Code, and section 1702(h) of the Small Business Job Protection Act of 1996, Public Law 104-88 (110 Stat. 1755). Changes concerning section 422 were made by section 251 of the Economic Recovery Tax Act c 1981, Public Law 97-34 (95 Stat. 172), which added section 422A to the Code. Related changes to section 422A were made by section 102(j) of the Technical Corrections Act of 1982, Public Law 97-448 (96 Stat. 2365), section 321(a) of Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085), section 1003(d) of TAMRA, and sections 11801 and 11821 of OBRA 90, which included re-designating section 422A as section 422 of the Code.

Regulations under section 421 governing the requirements for restricted stock options and qualified stock options, as well as options granted under an employee stocl purchase plan, were published in the **Federal Register** on December 9, 1957 (TD 6276), November 26, 1960 (TD 6500), January 19, 1961 (TD 6527), January 20, 1961 (TD 6540), December 12, 1963 (TD 6696), June 24, 1966 (TD 6887), July 24, 1978 (TL 7554), and November 3, 1980 (TD 7728). Temporary regulations under section 422A providing guidance and transitional rules related to incentive stock options were

published in the **Federal Register** on December 17, 1981 (TD 7799) and September 18, 1992 (TD 8435). Final regulations under section 422 related to stockholder approval were published in the **Federal Register** on December 1, 1988 (TD 8235) and November 29, 1991 (TD 8374). Regulations under section 425 were published in the **Federal Register** on June 23, 1966 (TD 6887).

Proposed changes to the final regulations under sections 421, 424, and 6039 and proposed regulations under section 422A were previously published in the **Federal Register** at 49 FR 4504 on February 7, 1984 (the 1984 proposed regulations). With the exception of certain stockholder approval rules, the 1984 proposed regulations provided a comprehensive set of rules under section 422 of the Code. The 1984 proposed regulations and the temporary regulations have been withdrawn. See 68 FR 34344.

On June 9, 2003, a notice of proposed rulemaking (REG-122917-02) was published in the **Federal Register** at 68 FR 34344 (the 2003 proposed regulations). No hearing concerning the 2003 proposed regulations was held; however, the IRS received written and electronic comments responding to this notice. After consideration of these comments, the 2003 proposed regulations are adopted as amended by this Treasury decision. The significant revisions are discussed below.

Explanation of Provisions

Overview

In general, the income tax treatment of the grant of an option to purchase stock in connection with the performance of services and of the transfer of stock pursuant to the exercise of such option is determined under section 83 of the Code and the regulations thereunder. However, section 421 of the Code provides special rules for

determining the income tax treatment of the transfer of shares of stock pursuant to the exercise of an option if the requirements of section 422(a) or 423(a), as applicable, are met. Section 422 applies to incentive stock options, and section 423 applies to options granted under an employee stock purchase plan (collectively, statutory options).

Under section 421, if a share of stock is transferred to an individual pursuant to the exercise of a statutory option, there is no income at the time of exercise of the option with respect to such transfer, and no deduction under section 162 is allowed to the employer corporation with respect to such transfer. However, pursuant to section 56(b)(3), section 421 does not apply with respect to the exercise of an incentive stock option for purposes of the individual alternative minimum tax.

Section 422(a) of the Code provides that section 421 applies to the transfer of stock to an individual pursuant to the exercise of an incentive stock option if (i) no disposition of the share is made within 2 years from the date of grant of the option or within 1 year from the date of transfer of the share, and (ii) at all times during the period beginning on the date of grant and ending on the day 3 months before the exercise of the option, the individual is an employee of either the corporation granting the option or a parent or subsidiary of such corporation, or a corporation (or a parent or subsidiary of such corporation) issuing or assuming a stock option in a transaction to which section 424(a) applies. Section 422(b) provides several requirements that must be met for an option to qualify as an incentive stock option. Section 422(c) provides special rules applicable to incentive stock options, and section 422(d) provides a $100,000 per year limitation with respect to incentive stock options.

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

These final regulations provide comprehensive rules governing incentive stock options that, as did the 2003 proposed regulations, incorporate many of the rules contained in the 1984 proposed regulations. However, the 2003 proposed regulations are re-numbered, and these final regulations adopt that reorganization. These final regulations also make changes to the final regulations under sections 421 and 424 to provide additional guidance, as discussed below, in certain areas, to reflect the new organizational structure of the statutory option rules (including the re-designation of §1.425-1 as §1.424-1), and to remove obsolete rules and cross-references.

Section 421: General Rules

Sections 422 and 423 provide that a statutory option may be granted to an individual who is an employee of the corporation granting the option, a parent or subsidiary of such corporation, or a corporation or a parent or subsidiary of such corporation issuing or assuming a stock option in a transaction to which section 424(a) applies.

Section 1.421-1(h) of the 2003 proposed regulations further describes the requisite employment relationship for purposes of a statutory option. The 2003 proposed regulations provide that an option is a statutory option only if, at the time the option is granted, the optionee is an employee of the corporation granting the option or a related corporation of such corporation. In the case of an assumption or substitution under §1.424-1(a), the optionee must, at the time of the assumption or substitution, be an employee of the corporation assuming or substituting the option or a related corporation of such corporation. In response to comments, these final regulations provide that in the case of an assumption or substitution under §1.424-1(a) an option also will be treated as granted to an employee of the granting corporation if the optionee is an individual who is in the 3-month period following termination of the employment relationship.

Section §1.421-1(h)(2) of the 2003 proposed regulations also provides that the employment relationship is considered to continue intact while an individual is on military leave, sick leave, or other bona fide leave of absence if the period of leave does not exceed 3 months, or if longer, so long as the individual's right to reemployment with the corporation granting the option (or a related corporation of such corporation) or a corporation assuming or substituting an option under §1.424-1(a) is guaranteed by statute or contract. Commentors requested clarification in the final regulations concerning whether the right to employment must be absolute and whether the right to reemployment provided by the Family Medical Leave Act or the Uniformed Services Employment and Reemployment Rights Act satisfies the requirements of this section. These final regulations provide that the right to reemployment must be provided by

statute or contract. Thus, for example, if an optionee is on leave pursuant to the Family Medical Leave Act, the Uniformed Services Employment and Reemployment Rights Act, or any similar statute providing for continued employment rights for an extended period of time, the employment relationship is considered intact.

Section 422: Incentive Stock Options

1. Special rules regarding disqualifying dispositions

The general rules concerning disqualifying dispositions are described in §1.421-2(b) of the 2003 proposed regulations. Under these rules, if there is a disqualifying disposition of a share of stock, the special tax treatment provided by section 421 and §1.421-2(a) does not apply to the transfer of the share. The effects of a disqualifying disposition are determined under section 83(a). Thus, in the taxable year in which the disqualifying disposition occurs, the individual must recognize compensation income equal to the fair market value of the stock (determined without regard to any lapse restriction and without regard to any reduction for any brokerage fees or other costs paid in connection with the disposition) on the date the stock is substantially vested less the exercise price. (See section 422(c)(2) concerning special rules that are applicable where the amount realized in a disposition is less than this difference.) A deduction is allowable for the taxable year in which such disqualifying disposition occurs to the employer corporation, its parent or subsidiary corporation, or a corporation substituting or assuming an option in a transaction to which §1.424-1(a) applies. Section 422(c)(2) and §1.422-1(b) of the 2003 proposed regulations provide special rules concerning disqualifying dispositions.

The application of the disqualifying disposition rules is described in several examples in §1.422-1(b)(3) of the 2003 proposed regulations. In Example 1 of §1.422-1(b)(3) of the 2003 proposed regulations, on exercise of an incentive stock option, the optionee receives vested stock and disposes of the stock before meeting the applicable holding period. In this example, the amount of compensation income is based on the fair market value of the stock on the date of exercise less the exercise price, and the section 422(a)(1) holding period is based on the date of exercise.

However, in Example 2 of §1.422-1(b)(3) of the 2003 proposed regulations, the optionee receives nonvested stock on exercise of an incentive stock option. This example retains the same holding period for the receipt of nonvested stock, but computes the amount of compensation income based on the date of vesting of the underlying stock (rather than the date of exercise).

Several commentors suggested that if the option is exercised for nonvested stock the compensation income should not be calculated on the date of vesting because section 83 does not apply to a transaction to which section 421 applies (and section 421(b) applies to a disqualifying disposition). Instead, the compensation income should be computed on the date of exercise. Alternatively, if the proposed rule is retained, commentors suggest that the final regulations and examples provide that an optionee may make a protective section 83(b) election on exercise of the option.

These final regulations retain the rules described in the 2003 proposed regulations, however, the examples in §1.422-1(b)(3) of the final regulations more fully describe the application of the disqualifying disposition rules. Specifically, Example 2 indicates that pursuant to section 83(e)(1) of the Code, section 83 does not apply to a

transaction to which section 421 applies. Thus, on exercise of a statutory option section 83 does not apply, and an optionee cannot make an effective election under section 83(b) for purposes of the income tax consequences on the date of exercise. However, an effective election under section 83(b) may be made for purposes of the alternative minimum tax, which calculates income as if section 83 applies. Example 2 also illustrates that on a disqualifying disposition, the rules of section 83 and the regulations thereunder (rather than section 422 and the regulations thereunder) are used to determine the amount of compensation includible in income. Applying the rules under section 83(a), the amount of compensation includible is the difference between the fair market value of the stock on the date the substantial risk of forfeiture lapses less the fair market value on the date of exercise. Additionally, Example 2 demonstrates that there is a transfer (as defined in §1.421-1(g) of the final regulations) of the stock on the date of exercise for purposes of the holding period requirement of section 422(a)(1). Thus, the holding period for the transfer of the stock for purposes of section 422 and the holding period requirements begins on the date of exercise (rather than the date of vesting). See also, §1.422-1(b)(3), Example 3. However, the amount of capital gain (if any) is computed from the date of vesting.

2. Shareholder approval

Among other requirements, to qualify as an incentive stock option, the option must be granted pursuant to a plan which is approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. See section 422(b) and §1.422-2(b)(2)(i) of the 2003 proposed regulations.

These final regulations retain the rules contained in the 2003 proposed regulations concerning shareholder approval. However, an additional example in §1.422-2(b)(6) illustrates the shareholder approval requirements where an incentive stock option plan is assumed in connection with a corporate transaction. See §1.422-2(b)(6), Example 3.

In Example 3 of §1.422-2(b)(6) of these final regulations, Corporation X maintains an incentive stock option plan, but Corporation Y does not maintain such a plan. The companies combine to form one corporation that will be named Y, the plan will be continued by Y, and future grants under the plan will be made by Y (the new combined entity). The consolidation agreement describes the plan, including the maximum aggregate number of shares available for issuance pursuant to incentive stock options under the plan after the consolidation and the employees eligible to receive options under the plan. Because there is a change in the granting corporation under §1.422-2(b)(3)(iii), Y is considered to have adopted a new plan that must satisfy the shareholder approval requirements. In this example, because the consolidation agreement describes the plan and indicates that it will continue after the consolidation, the shareholder approval requirements of §1.422-2(b)(3) are satisfied, and the plan is considered adopted and approved on the date the consolidation agreement is approved. See Rev. Rul. 68-233, 1968-1 C.B. 187.

3. Maximum aggregate number of shares

Section 422(b)(1) provides that an incentive stock option must be granted pursuant to a plan that includes the aggregate number of shares which may be issued under options. Section 1.422-2(b)(3)(i) of the 2003 proposed regulations provides that

the plan must designate the maximum aggregate number of shares that may be issued under the plan through incentive stock options, nonstatutory options, and all other stock-based awards to be granted under the plan.

In response to comments, these final regulations provide that the plan must designate the maximum aggregate number of shares that may be issued under the plan through incentive stock options. Thus, for example, if a corporation maintains an omnibus plan under which incentive stock options, nonstatutory options, and other stock-based awards may be made, the plan must contain a maximum number of shares that may be issued as incentive stock options. These final regulations do not require the plan to include the maximum number of shares that may be issued pursuant to nonstatutory options or other stock-based awards.

Commentators also asked whether the maximum aggregate number of shares that may be issued under an incentive stock option plan is affected by the use of outstanding shares used to exercise an option. Under these final regulations, only the net number of shares that are issued pursuant to the exercise of a statutory option are counted against the maximum aggregate number of shares. For example, if the exercise price of an option to purchase 100 shares equals the value of 20 shares, and the corporation permits the employee to use those 20 of the 100 shares to pay the exercise price of the option, and the corporation only issues 80 shares to the optionee, then 80 shares are counted against the maximum aggregate number of shares (rather than 100).

4. Option price

Under section 422(b)(4), the option price of an incentive stock option must not be less than the fair market value of the stock at the time the option is granted. The 2003 proposed regulations retain this rule, but also provide that the option price may be determined in any reasonable manner, including the valuation methods permitted under §20.2031-2 (Estate Tax Regulations), so long as the minimum price possible under the terms of the option is not less than the fair market value of the stock on the date of grant.

Section 1.422-2(e)(2)(i) of the 2003 proposed regulations provides that if a share of stock is transferred to an individual pursuant to the exercise of an incentive stock option, which fails to qualify as an incentive stock option because the exercise price is less than the fair market value of the underlying stock on the date of grant, such requirement is still considered to have been met if there was an attempt, made in good faith, to meet the option price requirements of §1.422-2(e)(1).

For nonpublicly traded stock, §1.422-2(e)(2)(iii) provides that if it is demonstrated that the fair market value of the stock on the date of grant was based on an average of the fair market values as of such date set forth in the opinions of completely independent and well-qualified experts, such a determination establishes that a good-faith attempt to meet the option price requirements of §1.422-2(e) was made. Taxpayers are required to retain adequate books and records to demonstrate that the option price requirements are satisfied. See section 6001.

Commentors suggested that the final regulations be revised to provide that a good-faith attempt to meet the option price requirements is demonstrated if the value of the stock is determined by a qualified appraiser (as defined in §1.170A-13(c)(5)), by an

individual (rather than more than one individual) who is not a qualified appraiser, or by the corporation at the date of grant. Because of concerns that the value determined under these approaches may not reliably reflect the fair market value of the stock on the date of grant, these final regulations retain the rules described in the 2003 proposed regulations.

5. $100,000 limitation

Section 422(d)(1) provides that, to the extent that the aggregate fair market value of stock with respect to which incentive stock options (determined without regard to section 422(d)) are exercisable for the first time by an individual during the calendar year (under all of the plans of the employer corporation and any related corporation) exceeds $100,000, such options are not treated as incentive stock options. Under section 422(d)(2), options are taken into account in the order in which they are granted. Section 422(d)(3) provides that the fair market value of stock is determined at the time the option is granted.

Section 1.422-4(b)(5)(ii) of the 2003 proposed regulations provides that if the option is not canceled, modified, or transferred prior to the year in which it would first become exercisable, it is treated as outstanding until the end of the year in which it first becomes exercisable. Commentors suggested that the final regulations permit an individual to cancel, modify, or transfer an option at any time prior to the date of exercise (rather than the year it first becomes exercisable). Because of concerns about the administrability of a rule that, for purposes of the $100,000 limitation, would permit an individual to determine the status of an option as statutory or nonstatutory until the

date of exercise, these final regulations retain the rule described in the 2003 proposed regulations.

Section 1.422-4(c) of the 2003 proposed regulations provides that the application of the $100,000 limitation may result in an option being treated, in part, as an incentive stock option and, in part, as a nonstatutory option. In response to comments, these final regulations provide additional guidance concerning the treatment of options (and the stock purchasable thereunder) that are bifurcated into an incentive stock option and nonstatutory option as a result of the application of the $100,000 limitation.

These final regulations provide that a corporation may issue a separate certificate for incentive stock option stock or designate such stock as incentive stock option stock in the corporation's transfer records or the plan records. The issuance of separate certificates or designation in plan records is not considered a modification under §1.424-1(e). However, in the absence of such an issuance or designation, shares are deemed purchased under an incentive stock option first to the extent of the $100,000 limitation, and then the excess shares are deemed purchased under a nonstatutory option.

Section 424: Definitions and Special Rules

1. Substitution, Assumption, and Modification of Options

Section 424(h)(1) provides that if the terms of an option are modified, extended, or renewed, such modification, renewal, or extension is treated as the grant of a new option. Under section 424(h)(3), the term modification (with certain exceptions) means any change in the terms of an option which gives the optionee additional benefits under the option. One exception to this definition is that a change in the terms of an option

attributable to a substitution or an assumption that meets the requirements of section 424(a) is not a modification of an option.

The 2003 proposed regulations provide that an eligible corporation (as defined in §1.424-1(a)(2)) may, by reason of a corporate transaction (as defined in §1.424-1(a)(3)), substitute a new statutory option (new option) for an outstanding statutory option (old option) or assume an old option without the substitution or assumption being considered a modification of the old option under section 424(h). These final regulations retain most of the rules contained in the 2003 proposed regulations, with certain changes.

Under the 2003 proposed regulations, a corporate transaction is (i) a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation; (ii) a distribution (excluding ordinary dividends), or change in the terms or number of outstanding shares of such corporation, such as a stock split or stock dividend (a change in capital structure); (iii) a change in the name of a corporation whose stock is purchasable under the old option; and (iv) such other corporate events as may be prescribed by the Commissioner in published guidance.

In response to comments, these final regulations provide that a "distribution" does not include a stock dividend or stock split (including a reverse stock split) that merely changes the number of outstanding shares of a corporation. Thus, an outstanding option is not treated as substituted or assumed under section 424(a) and §1.424-1(a) in connection with a stock dividend or stock split that merely changes the number of outstanding shares. Instead, the exercise price of an outstanding option may be proportionally adjusted to reflect a stock dividend or stock split that merely changes

the number of outstanding shares of a corporation under §1.424-1(e). This adjustment is not a modification of the option, and because the stock dividend or stock split is not a corporate transaction, the requirements of §1.424-1(a), including the spread and ratio tests, do not have to be satisfied.

The 2003 proposed regulations also provide that a new or assumed option must otherwise qualify as a statutory option. See §1.424-1(a)(5)(vi) of the 2003 proposed regulations. The 2003 proposed regulations provide that, except as necessary to comply with the specific requirements regarding substitution or assumption, such as the rules concerning ratio and spread, the option must comply with the requirements of §1.422-2 of the 2003 proposed regulations or 1.423-2, as applicable. Thus, under the 2003 proposed regulations, for example, the new option must be substituted, or the old option must be assumed, under a plan approved by the stockholders of the corporation substituting or assuming the option.

In Rev. Rul. 71-474 (1971-2 C.B. 215) involving qualified stock options, the IRS held that qualified stock options assumed by a corporation in a merger with the granting corporation retained their status as qualified stock options without approval of the assuming corporation's stockholders. In the ruling, the IRS indicated that approval of the persons who owned stock of the granting corporation at the time the plan originally was approved was sufficient to satisfy the stockholder approval requirements.

In response to comments, these final regulations refrain from imposing an additional stockholder approval requirement for statutory options that have been granted and are outstanding at the time of a corporate transaction. Thus, the requirement in §1.424-1(a)(5)(vi) of the 2003 proposed regulations is removed. Further,

the examples in §1.424-1(a)(10) of these final regulations demonstrate that if the shareholder approval requirements are met on the date of grant, a subsequent substitution or assumption of an outstanding option (old option) by an acquiring corporation does not require additional stockholder approval for the substituted or assumed option (new option) to continue to qualify as a statutory option. See, §1.424-1(a)(10), Example 9. For example, assume Corporation X maintains an incentive stock option plan that meets the requirements of §1.422-2 on the date of grant. E, an employee of X, holds outstanding incentive stock options to acquire X stock on exercise of the options. If Corporation Y acquires X and substitutes new options to acquire Y stock for the old options to acquire X stock held by E, the substitution of the new Y options does not require new stockholder approval. The result is the same if the options are assumed by Y. However, for future options granted under the plan to qualify as incentive stock options, the plan must be approved by the Y shareholders. (See, §1.422-2(b)(6) Example 3, for guidance concerning future grants under an option plan that is assumed in a corporate transaction.)

Finally, commentors requested guidance concerning the treatment of earn-out payments received by option holders in connection with a corporate transaction. Because of the factual nature of these transactions, these final regulations do not address the issues raised by these transactions. However, this area is currently under study and may be the subject of future guidance of general applicability under § 601.601(d)(2).

2. Modification, extension, or renewal of option

Section 424(h)(3) provides that a modification is any change in the terms of an option which gives the optionee additional benefits under the option, with certain specified exceptions.

Under §1.424-1(e)(4)(iii) of the 2003 proposed regulations, a change to an option providing that the optionee may receive an additional benefit under the option at the future discretion of the granting corporation is a modification of the option at the time the option is changed to provide the discretion. Additionally, the exercise of such discretion is a modification of the option. Although several commentors suggested that the final regulations provide that the later exercise of the discretion is not a modification of the option, these final regulations retain the rule contained in the 2003 proposed regulations.

However, as under the 2003 proposed regulations, it is not a modification for the granting corporation to exercise discretion specifically reserved under an option related to the payment of a bonus at the time of the exercise of the option, the availability of a loan at exercise, or the right to tender previously-owned stock for the stock purchasable under the option. A change to an option adding such discretion, however, is a modification.

Commentors suggested broadening this rule to include the exercise of any reserved discretion under the option. These final regulations, however, only expand this rule to provide that it is not a modification to exercise discretion specifically reserved under an option with respect to the payment of employment taxes and/or withholding taxes resulting from the exercise of a statutory option.

The 2003 proposed regulations also provide that an option is not modified merely because an optionee is offered a change in the terms of the option if the change is not made. These final regulations retain this rule, but also provide that if an offer to change the terms of the option remains outstanding for less than 30 days, the option is not modified. However, if the offer to change the terms of the option remains outstanding for 30 days or more, the option is treated as modified as of the date the offer to change the terms of the option is made.

Finally, commentors suggested that these final regulations provide an exception to the modification rule for an inadvertent change to a statutory option where the change is promptly reversed. In response, these final regulations provide that any inadvertent modification of an option is not treated as a modification to the extent the modification is reversed by the earlier of the date the option is exercised or the last day of the calendar year during which such change occurred.

Section 6039

Under section 1.6039-1(f) of the 2003 proposed regulations, the issue of furnishing electronic statements was reserved. These final regulations provide that the furnishing of statements in electronic form is permitted, provided the recipient consents to that means of delivery.

Effective date and reliance

These final regulations are effective on August 3, 2004. However, these final regulations provide special transitional and reliance rules.

For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR-279-81 (49 FR 4504), the 2003 proposed regulations

REG-122917-02 (68 FR 34344), or these final regulations until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004, taxpayers may rely on either the REG-122917-02 or the final regulations. Taxpayers may not rely on LR-279-81 or REG-122917-02 after December 31, 2005. Reliance on LR-279-81, REG-122917-02, or the final regulations must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the provision of employee statements provided under these proposed regulations will impose a minimal paperwork burden on most small entities (see the discussion under the heading "Paperwork Reduction Act" earlier in this preamble). Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these final regulations is being 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 proposed regulations is Erinn Madden, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Parts 1 and 14a

Income taxes, Reporting, and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 14a 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 * * *

§§1.421-1 through 1.421-6 [Removed]

Par. 2. Sections 1.421-1 through 1.421-6 are removed.

Par. 3. Section 1.421-7 is re-designated as §1.421-1 and is amended as follows:

1. In paragraph (a)(1), first sentence, the language "sections 421 through 425" is removed and "this §§1.421-1 through 1.424-1" is added in its place.

2. In paragraph (a)(1), first sentence, the language "includes" is removed, and "means" is added in its place.

3. In paragraph (a)(1), removing the second sentence.

4. Removing the last sentence of paragraph (a)(1) and adding two sentences in its place.

5. Revising paragraph (a)(3).

6. Revising paragraphs (b)(1) and (b)(2).

7. In paragraph (b)(3)(i), third sentence, removing the language "1.425-1" and inserting "1.424-1" in its place.

8. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	Remove	Add
1.421-1(b)(3)(ii) Example 1 first, second, third and fourth sentences	S-1	X
1.421-1(b)(3)(ii) Example 1 second sentence	1964	2004
1.421-1(b)(3)(ii) Example 1 third and fourth sentences	1965	2005
1.421-1(b)(3)(ii), Example 2, first and second sentences	1964	2004
1.421-1(b)(3)(ii) Example 2 first, third, and fourth sentences	S-1	X
1.421-1(b)(3)(ii) Example 2 third and fourth sentences	1965	2005

9. Revising the last sentence of paragraph (b)(3)(ii) Example 1.

10. Removing the last sentence of paragraph (b)(3)(ii) Example 2, and adding two sentences in its place.

11. Removing the first sentence of paragraph (c)(1) and adding two new sentences in its place.

12. In paragraph (c)(2), second sentence, the language "425" is removed and "424" is added in its place.

13. In paragraph (c)(3), second and last sentences, the language "1964" is removed and "2004" is added in its place.

14. In paragraph (c)(3), second sentence, the language "1965" is removed wherever it appears and "2005" is added in its place.

15. Revising paragraphs (d) and (e).

16. In paragraph (f), in the first sentence, the language "sections 421 through 425" is removed and "this section and §§1.421-2 through 1.424-1" is added in its place.

17. Revising the last sentence of paragraph (f).

18. In paragraph (g), first sentence, the language "sections 421 through 425" is removed and "this section and §§1.421-2 through 1.424-1" is added in its place.

19. Adding a new third, fourth, and fifth sentences to paragraph (g).

20. Revising the first, second, and third sentences of paragraph (h)(1).

21. Revising paragraph (h)(2).

22. In paragraph (h)(3), first sentence, the language "425" is removed and "424" is added in its place.

23. In paragraph (h)(3), last sentence, the language "or assuming" is removed and "the option or substituting or assuming the option" is added in its place.

24. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	Remove	Add
1.421-1(h)(4) Example 1, first sentence	1964	2004
1.421-1(h)(4) Example 1, second and last sentences	1965	2005
1.421-1(h)(4) Example 2, first sentence	425	424
1.421-1(h)(4) Example 2, first sentence	issuing	substituting
1.424-1(h)(4) Example 2,last sentence	1965	2005
1.421-1(h)(4) Example 2, last sentence	for A is then employed by a corporation which issued an option under section 425(a).	to the transfer of the M stock because, at all times during the period beginning with the date of grant of the X option and ending with the date of exercise of the M option, A was an employee of the corporation granting the option or substituting or assuming the option under §1.424-1(a).
1.421-1(h)(4) Example 3, second sentence	1964	2004
1.421-1(h)(4) Example 3, third, fourth, and fifth sentences	1965	2005
1.421-1(h)(4) Example 4, first sentence	425(a)	424(a)

1.421-1(h)(4) Example 5, first sentence	qualified stock	statutory
1.421-1(h)(4) Example 6, first sentence	an employment contract with M which provides that upon the termination of any military duty E may be required to serve, E will be entitled to reemployment with M or a parent or subsidiary of M.	a right to reemployment with M or a related corporation on the termination of any military duty E may be required to serve.
1.421-1(h)(4) Example 6, third sentence	of M	of M or a related corporation
1.421-1(h)(4) Example 6, last sentence	can apply	applies
1.421-1(h)(4) Example 7, first and last sentences	a qualified stock	an incentive
1.421-1(h)(4) Example 7, first sentence	parent or subsidiary	related corporation
1.421-1(h)(4) Example 7 last sentence	its parent and subsidiary corporation	related corporations
1.421-1(h)(4) Example 7, last sentence	terminated	deemed terminated

25. Revising paragraph (i).

26. Adding paragraph (j).

The additions and revisions read as follows:

§1.421-1 Meaning and use of certain terms.

(a) * * * (1) * * * While no particular form of words is necessary, the option must express, among other things, an offer to sell at the option price, the maximum number

of shares purchasable under the option, and the period of time during which the offer remains open. The term option includes a warrant that meets the requirements of this paragraph (a)(1).

* * * * *

(3) An option must be in writing (in paper or electronic form), provided that such writing is adequate to establish an option right or privilege that is enforceable under applicable law.

(b) Statutory options. (1) The term statutory option, for purposes of this section and §§1.421-2 through 1.424-1, means an incentive stock option, as defined in §1.422-2(a), or an option granted under an employee stock purchase plan, as defined in §1.423-2.

(2) An option qualifies as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom the option was granted, and is exercisable, during the lifetime of such individual, only by such individual. See §§1.422-2(a)(2)(v) and 1.423-2(j). Accordingly, an option which is transferable or transferred by the individual to whom the option is granted during such individual's lifetime, or is exercisable during such individual's lifetime by another person, is not a statutory option. However, if the option or the plan under which the option was granted contains a provision permitting the individual to designate the person who may exercise the option after such individual's death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a statutory option. A pledge of the stock purchasable under an option as security for a loan that is used to pay the option price does not cause the option to violate the nontransferability

requirements of this paragraph (b). Also, the transfer of an option to a trust does not disqualify the option as a statutory option if, under section 671 and applicable State law, the individual is considered the sole beneficial owner of the option while it is held in the trust. If an option is transferred incident to divorce (within the meaning of section 1041) or pursuant to a domestic relations order, the option does not qualify as a statutory option as of the day of such transfer. For the treatment of nonstatutory options, see §1.83-7.

(3) * * *

(ii) * * *

Example 1. * * * Because X was a subsidiary of P on the date of the grant of the statutory option, the option does not fail to be a statutory option even though X ceases to be a subsidiary of P.

Example 2. * * * Because X was not a subsidiary of S or P on the date of the grant of the option, the option is not a statutory option even though X later becomes a subsidiary of P. See §§1.422-2(a)(2) and 1.423-2(b).

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

* * * * *

(d) Stock and voting stock. (1) For purposes of this section and §§1.421-2 through 1.424-1, the term stock means capital stock of any class, including voting or nonvoting common or preferred stock. Except as otherwise provided, the term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term stock as used in such sections, provided such stock otherwise possesses the rights and characteristics of capital stock.

(2) For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders under §1.422-2(b) or 1.423-2(c) or whether the limitations pertaining to voting power contained in §§1.422-2(f) and 1.423-2(d) have been met, stock which does not have voting rights until the happening of an event, such as the default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Generally, stock which does not possess a general voting power, and may vote only on particular questions, is not voting stock. However, if such stock is entitled to vote on whether a stock option plan may be adopted, it is voting stock.

(3) In general, for purposes of this section and §§1.421-2 through 1.424-1, ownership interests other than capital stock are considered stock.

(e) Option price. (1) For purposes of this section and §§1.421-2 through 1.424-1, the term option price, price paid under the option, or exercise price means the consideration in cash or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term option price does not

include any amounts paid as interest under a deferred payment arrangement or treated as interest.

(2) Any reasonable valuation method may be used to determine whether, at the time the option is granted, the option price satisfies the pricing requirements of sections 422(b)(4), 422(c)(5), 422(c)(7), and 423(b)(6) with respect to the stock subject to the option. Such methods include, for example, the valuation method described in §20.2031-2 of this chapter (Estate Tax Regulations).

(f) Exercise. * * * An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option to the extent the payments made remain subject to withdrawal by or refund to the employee.

(g) Transfer. * * * For purposes of section 422, a transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. See §1.422-1(b)(3) Example 3. A transfer does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a specified period of time, or the share is subject to a right of first refusal or a right to reacquire the share at the share's fair market value at the time of sale.

(h) Employment relationship. (1) An option is a statutory option only if, at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation. If the option has been assumed or a new option has been substituted in its place under §1.424-1(a), the optionee must, at the time of such substitution or assumption, be an employee (or a former employee

within the 3-month period following termination of the employment relationship) of the corporation so substituting or assuming the option, or a related corporation of such corporation. The determination of whether the optionee is an employee at the time the option is granted (or at the time of the substitution or assumption under §1.424-1(a)) is made in accordance with section 3401(c) and the regulations thereunder. * * *

(2) In addition, §1.421-2(a) is applicable to the transfer of a share pursuant to the exercise of the statutory option only if the optionee is, at all times during the period beginning with the date of the granting of such option and ending on the day 3 months before the date of such exercise, an employee of either the corporation granting such option, a related corporation of such corporation, or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to which §1.424-1(a) applies. For purposes of the preceding sentence, the employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other bona fide leave of absence (such as temporary employment by the Government) if the period of such leave does not exceed 3 months, or if longer, so long as the individual's right to reemployment with the corporation granting the option (or a related corporation of such corporation) or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to which §1.424-1(a) applies, is provided either by statute or by contract. If the period of leave exceeds 3 months and the individual's right to reemployment is not provided either by statute or by contract, the employment relationship is deemed to terminate on the first day immediately following such three-month period. Thus, if the option is not exercised before such deemed termination of employment, §1.421-2(a) applies to the transfer of a

share pursuant to an exercise of the option only if the exercise occurs within 3 months from the date the employment relationship is deemed terminated.

* * * *

(i) Additional definitions. (1) Corporation. For purposes of this section and §§1.421-2 through 1.424-1, the term corporation has the meaning prescribed by section 7701(a)(3) and §301.7701-2(b) of this chapter. For example, a corporation for purposes of the preceding sentence includes an S corporation (as defined in section 1361), a foreign corporation (as defined in section 7701(a)(5)), and a limited liability company that is treated as a corporation for all Federal tax purposes.

(2) Parent corporation and subsidiary corporation. For the definition of the terms parent corporation (and parent) and subsidiary corporation (and subsidiary), for purposes of this section and §§1.421-2 through 1.424-1, see §1.424-1(f)(i) and (ii), respectively. Related corporation as used in this section and in §§1.421-2 through 1.424-1 means either a parent corporation or subsidiary corporation.

(j) Effective date-- (1) In general. These regulations are effective on August 3, 2004.

(2) Reliance and transition period. For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR-279-81 (49 FR 4504), the 2003 proposed regulations REG-122917-02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6

months after August 3, 2004, taxpayers may rely on either the REG-122917-02 or this section. Taxpayers may not rely on LR-279-81 or REG-122917-02 after December 31, 2005. Reliance on LR-279-81, REG-122917-02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

Par. 4. Section 1.421-8 is re-designated as 1.421-2 and is amended by:

1. Revising paragraphs (a)(1), (b), and (c)(1).

2. In paragraph (c)(2), first sentence, add the phrase "for purposes of section 423(c)" at the end of the first sentence.

3. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	Remove	Add
1.421-2(c)(2), second sentence	, or 424(c)(1)	
1.421-2(c)(2), third sentence	or 424(c)(1)	
1.421-2(c)(3)(i), first, second, and third sentences	422(c)(1), 423(c), or 424(c)(1)	423(c)
1.421-2(c)(3)(ii) Example, first sentence	1964	2004
1.421-2(c)(3)(ii) Example, third, fifth, and sixth sentences	1966	2006

4. Removing paragraph (c)(4)(i) and redesignating paragraphs (c)(4)(ii) through (c)(4)(iv) as paragraphs (c)(4)(i) through (c)(4)(iii), respectively.

5. In newly designated paragraph (c)(4)(i)(a), first sentence, removing the phrase "In the case of an employee dying after December 31, 1956" and adding "In the case of the death of an optionee" in its place.

6. Removing Example (1) in newly designated paragraph (c)(4)(iii) and redesignating Examples (2) through (5) as Examples (1) through (4), respectively.

7. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	Remove	Add
1.421-2(c)(4)(i)(a), last sentence	422(c)(1), 423(c), or 424(c)(1)	423(c)
1.421-2(c)(4)(i)(b), first, second, and last sentences	422(c)(1), 423(c), or 424(c)(1)	423(c)
1.421-2(c)(4)(i)(c), first sentence	422(c)(1), 423(c), or 424(c)(1)	423(c)
1.421-2(c)(4)(iii) Example 1, first sentence	1964	2005
1.421-2(c)(4)(iii), Example 1, eighth sentence	subdivision (ii)(b) of this subparagraph	paragraph (c)(4)(i)(b) of this section
1.421-2(c)(4)(iii), Example 1, third and fifth sentences	1966	2006

1.421-2(c)(4)(iii) Example 1, ninth sentence	subdivision (ii)(c) of this subparagraph	paragraph (c)(4)(i)(c) of this section
1.421-2(c)(4)(iii) Example 2, second and fifth sentences	subdivision (ii)(a) of this subparagraph	paragraph (c)(4)(i)(a) of this section
1.421-2(c)(4)(iii) Example 2, fifth sentence	subdivision (ii)(b) of this subparagraph	paragraph (c)(4)(i)(b) of this section
1.421-2(c)(4)(iii) Example 2, first sentence	example (2)	Example 1
1.421-2(c)(4)(iii) Example 3, first sentence	example (2)	Example 1
1.421-2(c)(4)(iii), Example 3, second and fourth sentences	subdivision (ii)(a) of this subparagraph	paragraph (c)(4)(i)(a) of this section
1.421-2(c)(4)(iii) Example 3, fourth sentence	subdivision (ii)(c) of this subparagraph	paragraph (c)(4)(i)(c) of this section
1.421-2(c)(4)(iii) Example 4, first sentence	example (2)	Example 1
1.421-2(c)(4)(iii) Example 4, first sentence	1966	2006
1.421-2(c)(4)(iii) Example 4, first and second sentences	1967	2007
1.421-2(c)(iii) Example 4, third, fifth, and sixth sentences	subdivision (ii)(a) of this subparagraph	paragraph (c)(4)(i)(a) of this section

1.421-2(c)(4)(iii) Example 4, fifth and sixth sentences	subdivision (ii)(b) of this subparagraph	paragraph (c)(4)(i)(b) of this section
1.421-2(c)(4)(iii) Example 4, sixth sentence	subdivision (ii)(c) of this subparagraph	paragraph (c)(4)(i)(c) of this section

8. Revising paragraph (d).

9. Adding paragraph (f).

The revisions read as follows:

§ 1.421-2 General rules.

(a) Effect of qualifying transfer. (1) If a share of stock is transferred to an individual pursuant to the individual's exercise of a statutory option, and if the requirements of §1.422-1(a) (relating to incentive stock options) or §1.423-1(a) (relating to employee stock purchase plans) whichever is applicable, are met, then--

(i) No income results under section 83 at the time of the transfer of such share to the individual upon the exercise of the option with respect to such share;

(ii) No deduction under sections 83(h) or 162 or the regulations thereunder (relating to trade or business expenses) is allowable at any time with respect to the share so transferred; and

(iii) No amount other than the price paid under the option is considered as received by the employer corporation, a related corporation of such corporation, or a corporation substituting or assuming a stock option in a transaction to which §1.424-1(a) (relating to corporate reorganizations, liquidations, etc.) applies, for the share so transferred.

* * * * *

(b) Effect of disqualifying disposition. (1)(i) The disposition (as defined in §1.424-1(c)) of a share of stock acquired by the exercise of a statutory option before the expiration of the applicable holding periods as determined under §1.422-1(a) or 1.423-1(a) is a disqualifying disposition and makes paragraph (a) of this section inapplicable to the transfer of such share. See section 83(a) to determine the amount includible on a disqualifying disposition. The income attributable to such transfer (determined without reduction for any brokerage fees or other costs paid in connection with the disposition) is treated by the individual as compensation income received in the taxable year in which such disqualifying disposition occurs. A deduction attributable to such transfer is allowable, to the extent otherwise allowable under section 162, for the taxable year in which such disqualifying disposition occurs to the employer corporation, or a related corporation of such corporation, or a corporation substituting or assuming an option in a transaction to which §1.424-1(a) applies. Additionally, the amount allowed as a deduction must be determined as if the requirements of section 83(h) and §1.83-6(a) apply. No amount is treated as income, and no amount is allowed as a deduction, for any taxable year other than the taxable year in which the disqualifying disposition occurs. If the amount realized on the disposition exceeds (or is less than) the sum of the amount paid for the share and the amount of compensation income recognized as a result of such disposition, the extent to which the difference is treated as gain (or loss) is determined under the rules of section 302 or 1001, as applicable.

(ii) The following examples illustrate the principles of this paragraph (b):

Example 1. On June 1, 2006, X Corporation grants an incentive stock option to A, an employee of X, entitling A to purchase 100 shares of X stock at $10 per share. On August 1, 2006, A exercises the option when the fair market value of X stock is $20

per share, and 100 shares of X stock are transferred to A on that date. On December 15, 2007, A sells the stock for $20 per share. Because A disposed of the stock before June 2, 2008, A did not satisfy the holding period requirements of §1.422-1(a). Under paragraph (b)(1)(i) of this section, A therefore made a disqualifying disposition of the stock. Thus, paragraph (a) of this section is inapplicable to the transfer of the shares, and A must include the compensation income attributable to the transfer of the shares in gross income in the year of the disqualifying disposition. The amount of compensation income A must include in income is $1,000 ($2,000, the fair market value of X stock on transfer less $1,000, the exercise price per share). If the requirements of §83(h) and §1.83-6(a) are satisfied and otherwise allowable under section162, X is allowed a deduction of $1,000 for its taxable year in which the disqualifying disposition occurs.

Example 2. Y Corporation grants an incentive stock option for 100 shares of its stock to E, an employee of Y. The option has an exercise price of $10 per share. E exercises the option and is transferred the shares when the fair market value of a share of Y stock is $30. Before the applicable holding periods are met, Y redeems the shares for $70 per share. Because the holding period requirements of §1.422-1(a) are not met, the redemption of the shares is a disqualifying disposition of the shares. Under paragraph (b)(1)(i) of this section, A made a disqualifying disposition of the stock. Thus, paragraph (a) of this section is inapplicable to the transfer of the shares, and E must include the compensation income attributable to the transfer of the shares in gross income in the year of the disqualifying disposition. The amount of compensation income that E must include in income is $2,000 ($3,000, the fair market value of Y stock on transfer, less $1,000, the exercise price paid by E). The character of the additional gain that is includible in E's income as a result of the redemption is determined under the rules of section 302. If the requirements of §83(h) and §1.83-6(a) are satisfied and otherwise allowable under section 162, Y is allowed a deduction for the taxable year in which the disqualifying disposition occurs for the compensation income of $2,000. Y is not allowed a deduction for the additional gain includible in E's income as a result of the redemption.

(2) If an optionee transfers stock acquired through the optionee's exercise of a statutory option prior to the expiration of the applicable holding periods, paragraph (a) of this section continues to apply to the transfer of the stock pursuant to the exercise of the option if such transfer is not a disposition of the stock as defined in §1.424-1(c) (for example, a transfer from a decedent to the decedent's estate or a transfer by bequest or inheritance). Similarly, a subsequent transfer by the executor, administrator, heir, or legatee is not a disqualifying disposition by the decedent. If a statutory option is

exercised by the estate of the optionee or by a person who acquired the option by bequest or inheritance or by reason of the death of such optionee, see paragraph (c) of this section. If a statutory option is exercised by the individual to whom the option was granted and the individual dies before the expiration of the holding periods, see paragraph (d) of this section.

(3) For special rules relating to the disqualifying disposition of a share of stock acquired by exercise of an incentive stock option, see §§1.422-5(b)(2) and 1.424-1(c)(3).

(c) Exercise by estate. (1) If a statutory option is exercised by the estate of the individual to whom the option was granted (or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual), paragraph (a) of this section applies to the transfer of stock pursuant to such exercise in the same manner as if the option had been exercised by the deceased optionee. Consequently, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to the exercise of the option. Paragraph (a) of this section applies even if the executor, administrator, or such person disposes of the stock so acquired before the expiration of the applicable holding periods as determined under §1.422-1(a) or 1.423-1(a). This special rule does not affect the applicability of section 423(c), relating to the estate's or other qualifying person's recognition of compensation income, or section 1222, relating to what constitutes a short-term and long-term capital gain or loss. Paragraph (a) of this section also applies even if the executor, administrator, or such person does not exercise the option within three months after the death of the individual or is not employed as described in §1.421-1(h),

either when the option is exercised or at any time. However, paragraph (a) of this section does not apply to a transfer of shares pursuant to an exercise of the option by the estate or by such person unless the individual met the employment requirements described in §1.421-1(h) either at the time of the individual's death or within three months before such time (or, if applicable, within the period described in §1.422-1(a)(3)). Additionally, paragraph (a) of this section does not apply if the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual. For example, if the option is sold by the estate, paragraph (a) of this section does not apply to the transfer of stock pursuant to an exercise of the option by the buyer, but if the option is distributed by the administrator to an heir as part of the estate, paragraph (a) of this section applies to the transfer of stock pursuant to an exercise of the option by such heir.

* * * * *

(d) Option exercised by the individual to whom the option was granted if the individual dies before expiration of the applicable holding periods. If a statutory option is exercised by the individual to whom the option was granted and such individual dies before the expiration of the applicable holding periods as determined under §1.422-1(a) or 1.423-1(a), paragraph (a) of this section does not become inapplicable if the executor or administrator of the estate of such individual, or any person who acquired such stock by bequest or inheritance or by reason of the death of such individual, disposes of such stock before the expiration of such applicable holding periods. This rule does not affect the applicability of section 423(c), relating to the individual's recognition of

compensation income, or section 1222, relating to what constitutes a short-term and long-term capital gain or loss.

* * * * *

(f) Effective date-- (1) In general. These regulations are effective on August 3, 2004.

(2) Reliance and transition period. For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR-279-81 (49 FR 4504), the 2003 proposed regulations REG-122917-02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004, taxpayers may rely on either the REG-122917-02 or this section. Taxpayers may not rely on LR-279-81 or REG-122917-02 after December 31, 2005. Reliance on LR-279-81, REG-122917-02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

Par. 5. Section 1.422-1 is added to read as follows:

§1.422-1 Incentive stock options; general rules.

(a) Applicability of section 421(a). (1)(i) Section 1.421-2(a) applies to the transfer of a share of stock to an individual pursuant to the individual's exercise of an incentive stock option if the following conditions are satisfied--

(A) The individual makes no disposition of such share before the later of the expiration of the 2-year period from the date of grant of the option pursuant to which such share was transferred, or the expiration of the 1-year period from the date of transfer of such share to the individual; and

(B) At all times during the period beginning on the date of grant of the option and ending on the day 3 months before the date of exercise, the individual was an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to which §1.424-1(a) applies.

(ii) For rules relating to the disposition of shares of stock acquired pursuant to the exercise of a statutory option, see §1.424-1(c). For rules relating to the requisite employment relationship, see §1.421-1(h).

(2)(i) The holding period requirement of section 422(a)(1), described in paragraph (a)(1)(i)(A) of this section, does not apply to the transfer of shares by an insolvent individual described in this paragraph (a)(2). If an insolvent individual holds a share of stock acquired pursuant to the individual's exercise of an incentive stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding, neither such transfer, nor any other transfer of such share for the benefit of the individual's creditors in such proceeding is a disposition of such share for purposes of this paragraph (a). For purposes of this paragraph (a)(2), an individual is insolvent only if the individual's liabilities exceed the individual's assets or the individual is unable to satisfy the individual's liabilities as they become due. See section 422(c)(3).

(ii) A transfer by the trustee or other fiduciary that is not treated as a disposition for purposes of this paragraph (a) may be a sale or exchange for purposes of recognizing capital gain or loss with respect to the share transferred. For example, if the trustee transfers the share to a creditor in an insolvency proceeding, capital gain or loss must be recognized by the insolvent individual to the extent of the difference between the amount realized from such transfer and the adjusted basis of such share.

(iii) If any transfer by the trustee or other fiduciary (other than a transfer back to the insolvent individual) is not for the exclusive benefit of the creditors in an insolvency proceeding, then whether such transfer is a disposition of the share by the individual for purposes of this paragraph (a) is determined under §1.424-1(c). Similarly, if the trustee or other fiduciary transfers the share back to the insolvent individual, any subsequent transfer of the share by such individual which is not made in respect of the insolvency proceeding may be a disposition of the share for purposes of this paragraph (a).

(3) If the employee exercising an option ceased employment because of permanent and total disability, within the meaning of section 22(e)(3), 1 year is used instead of 3 months in the employment period requirement of paragraph (a)(1)(i)(B) of this section.

(b) Failure to satisfy holding period requirements--(1) General rule. For general rules concerning a disqualifying disposition of a share of stock acquired pursuant to the exercise of an incentive stock option, see §1.421-2(b)(1).

(2)(i) Special rule. If an individual makes a disqualifying disposition of a share of stock acquired by the exercise of an incentive stock option, and if such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to the

individual, then, under this paragraph (b)(2)(i), the amount includible (determined without reduction for brokerage fees or other costs paid in connection with the disposition) in the gross income of such individual, and deductible from the income of the employer corporation (or a related corporation of such corporation, or of a corporation substituting or assuming the option in a transaction to which §1.424-1(a) applies) as compensation attributable to the exercise of such option, shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share. Subject to the special rule provided by this paragraph (b)(2)(i), the amount of compensation attributable to the exercise of the option is determined under section 83(a); see §1.421-2(b)(1)(i).

(ii) Limitation to special rule. The special rule described in paragraph (b)(2)(i) of this section does not apply if the disposition is a sale or exchange with respect to which a loss (if sustained) would not be recognized by the individual. Thus, for example, if a disqualifying disposition is a sale described in section 1091 (relating to loss from wash sales of stock or securities), a gift (or any other transaction which is not at arm's length), or a sale described in section 267(a)(1) (relating to sales between related persons), the special rule described in paragraph (b)(2)(i) of this section does not apply because a loss sustained in any such transaction would not be recognized.

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

Example 1. Disqualifying disposition of vested stock. On June 1, 2006, X Corporation grants an incentive stock option to A, an employee of X Corporation, entitling A to purchase one share of X Corporation stock. On August 1, 2006, A exercises the option, and the share of X Corporation stock is transferred to A on that date. The option price is $100 (the fair market value of a share of X Corporation stock

on June 1, 2006), and the fair market value of a share of X Corporation stock on August 1, 2006 (the date of transfer) is $200. The share transferred to A is transferable and not subject to a substantial risk of forfeiture. A makes a disqualifying disposition by selling the share on June 1, 2007, for $250. The amount of compensation attributable to A's exercise is $100 (the difference between the fair market value of the share at the date of transfer, $200, and the amount paid for the share, $100). Because the amount realized ($250) is greater than the value of the share at transfer ($200), paragraph (b)(2)(i) of this section does not apply and thus does not affect the amount includible as compensation in A's gross income and deductible by X. A must include in gross income for the taxable year in which the sale occurred $100 as compensation and $50 as capital gain ($250, the amount realized from the sale, less A's basis of $200 (the $100 paid for the share plus the $100 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option)). If the requirements of section 83(h) and §1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $100 for compensation attributable to A's exercise of the incentive stock option.

Example 2. Disqualifying disposition of unvested stock. Assume the same facts as in Example 1, except that the share of X Corporation stock received by A is subject to a substantial risk of forfeiture and not transferable for a period of six months after such exercise. Assume further that the fair market value of X Corporation stock is $225 on February 1, 2007, the date on which the six-month restriction lapses. Because section 83 does not apply for ordinary income tax purposes on the date of exercise, A cannot make an effective section 83(b) election at that time (although such an election is permissible for alternative minimum tax purposes). Additionally, at the time of the disposition, section 422 and §1.422-1(a) no longer apply, and thus, section 83(a) is used to measure the consequences of the disposition. The amount of compensation attributable to A's exercise of the option and disqualifying disposition of the share is $125 (the difference between the fair market value of the share on the date that the restriction lapsed, $225, and the amount paid for the share, $100). Because the amount realized ($225) is greater than the value of the share at transfer ($200), paragraph (b)(2)(i) of this section does not apply and thus does not affect the amount includible as compensation in A's gross income and deductible by X. A must include $125 of compensation income and $25 of capital gain in gross income for the taxable year in which the disposition occurs ($250, the amount realized from the sale, less A's basis of $225 (the $100 paid for the share plus the $125 increase in basis resulting from the inclusion of that amount of compensation in A's gross income)). If the requirements of section 83(h) and §1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $125 for the compensation attributable to A's exercise of the option.

Example 3. (i) Disqualifying disposition and application of special rule. Assume the same facts as in Example 1, except that A sells the share for $150 to M.

(ii) If the sale to M is a disposition that meets the requirements of paragraph (b)(2)(i) of this section, instead of $100 which otherwise would have been includible as compensation under §1.83-7, under paragraph (b)(2)(i) of this section, A must include only $50 (the excess of the amount realized on such sale, $150, over the adjusted basis of the share, $100) in gross income as compensation attributable to the exercise of the incentive stock option. Because A's basis for the share is $150 (the $100 which A paid for the share, plus the $50 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option), A realizes no capital gain or loss as a result of the sale. If the requirements of section 83(h) and §1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $50 for the compensation attributable to A's exercise of the option and disqualifying disposition of the share.

(iii) Assume the same facts as in paragraph (i) of this Example 3, except that 10 days after the sale to M, A purchases substantially identical stock. Because under section 1091(a) a loss (if it were sustained on the sale) would not be recognized on the sale, under paragraph (b)(2)(ii) of this section, the special rule described in paragraph (b)(2)(i) of this section does not apply. A must include $100 (the difference between the fair market value of the share on the date of transfer, $200, and the amount paid for the share, $100) in gross income as compensation attributable to the exercise of the option for the taxable year in which the disqualifying disposition occurred. A recognizes no capital gain or loss on the transaction. If the requirements of section 83(h) and §1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs X Corporation is allowed a $100 deduction for compensation attributable to A's exercise of the option and disqualifying disposition of the share.

(iv) Assume the same facts as in paragraph (ii) of this Example 3, except that A sells the share for $50. Under paragraph (b)(2)(i) of this section, A is not required to include any amount in gross income as compensation attributable to the exercise of the option. A is allowed a capital loss of $50 (the difference between the amount realized on the sale, $50, and the adjusted basis of the share, $100). X Corporation is not allowed any deduction attributable to A's exercise of the option and disqualifying disposition of the share.

(c) Failure to satisfy employment requirement. Section 1.421-2(a) does not apply to the transfer of a share of stock pursuant to the exercise of an incentive stock option if the employment requirement, as determined under paragraph (a)(1)(i)(B) of this section, is not met at the time of the exercise of such option. Consequently, the effects of such

a transfer are determined under the rules of §1.83-7. For rules relating to the employment relationship, see §1.421-1(h).

Par. 6. Section 1.422-2 is added to read as follows:

§1.422-2 Incentive stock options defined.

(a) Incentive stock option defined--(1) In general. The term incentive stock option means an option that meets the requirements of paragraph (a)(2) of this section on the date of grant. An incentive stock option is also subject to the $100,000 limitation described in §1.422-4. An incentive stock option may contain a number of permissible provisions that do not affect the status of the option as an incentive stock option. See §1.422-5 for rules relating to permissible provisions of an incentive stock option.

(2) Option requirements. To qualify as an incentive stock option under this section, an option must be granted to an individual in connection with the individual's employment by the corporation granting such option (or by a related corporation as defined in §1.421-1(i)(2)), and granted only for stock of any of such corporations. In addition, the option must meet all of the following requirements--

(i) It must be granted pursuant to a plan that meets the requirements described in paragraph (b) of this section;

(ii) It must be granted within 10 years from the date of the adoption of the plan or the date such plan is approved by the stockholders, whichever is earlier (see paragraph (c) of this section);

(iii) It must not be exercisable after the expiration of 10 years from the date of grant (see paragraph (d) of this section);

(iv) It must provide that the option price per share is not less than the fair market value of the share on the date of grant (see paragraph (e) of this section);

(v) By its terms, it must not be transferrable by the individual to whom the option is granted other than by will or the laws of descent and distribution, and must be exercisable, during such individual's lifetime, only by such individual (see §§1.421-1(b)(2) and 1.421-2(c)); and

(vi) Except as provided in paragraph (f) of this section, it must be granted to an individual who, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the corporation employing such individual or of any related corporation of such corporation.

(3) Amendment of option terms. Except as otherwise provided in §1.424-1, the amendment of the terms of an incentive stock option may cause it to cease to be an option described in this section. If the terms of an option that has lost its status as an incentive stock option are subsequently changed with the intent to re-qualify the option as an incentive stock option, such change results in the grant of a new option on the date of the change. See §1.424-1(e).

(4) Terms provide option not an incentive stock option. If the terms of an option, when granted, provide that it will not be treated as an incentive stock option, such option is not treated as an incentive stock option.

(b) Option plan--(1) In general. An incentive stock option must be granted pursuant to a plan that meets the requirements of this paragraph (b). The authority to grant other stock options or other stock-based awards pursuant to the plan, where the exercise of such other options or awards does not affect the exercise of incentive stock

options granted pursuant to the plan, does not disqualify such incentive stock options. The plan must be in writing or electronic form, provided that such writing or electronic form is adequate to establish the terms of the plan. See §1.422-5 for rules relating to permissible provisions of an incentive stock option.

(2) Stockholder approval. (i) The plan required by this paragraph (b) must be approved by the stockholders of the corporation granting the incentive stock option within 12 months before or after the date such plan is adopted. Ordinarily, a plan is adopted when it is approved by the granting corporation's board of directors, and the date of the board's action is the reference point for determining whether stockholder approval occurs within the applicable 24-month period. However, if the board's action is subject to a condition (such as stockholder approval) or the happening of a particular event, the plan is adopted on the date the condition is met or the event occurs, unless the board's resolution fixes the date of approval as the date of the board's action.

(ii) For purposes of paragraph (b)(2)(i) of this section, the stockholder approval must comply with the rules described in §1.422-3.

(iii) The provisions relating to the maximum aggregate number of shares to be issued under the plan (described in paragraph (b)(3) of this section) and the employees (or class or classes of employees) eligible to receive options under the plan (described in paragraph (b)(4) of this section) are the only provisions of a stock option plan that, if changed, must be re-approved by stockholders for purposes of section 422(b)(1). Any increase in the maximum aggregate number of shares that may be issued under the plan (other than an increase merely reflecting a change in the number of outstanding shares, such as a stock dividend or stock split), or change in the designation of the

employees (or class or classes of employees) eligible to receive options under the plan is considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period. In addition, a change in the granting corporation or the stock available for purchase or award under the plan is considered the adoption of a new plan requiring new stockholder approval within the prescribed 24-month period. Any other changes in the terms of an incentive stock option plan are not considered the adoption of a new plan and, thus, do not require stockholder approval.

(3) Maximum aggregate number of shares. (i) The plan required by this paragraph (b) must designate the maximum aggregate number of shares that may be issued under the plan through incentive stock options. If nonstatutory options or other stock-based awards may be granted, the plan may separately designate terms for each type of option or other stock-based awards and designate the maximum number of shares that may be issued under such option or other stock-based awards. Unless otherwise specified, all terms of the plan apply to all options and other stock-based awards that may be granted under the plan.

(ii) A plan that merely provides that the number of shares that may be issued as incentive stock options under such plan may not exceed a stated percentage of the shares outstanding at the time of each offering or grant under such plan does not satisfy the requirement that the plan state the maximum aggregate number of shares that may be issued under the plan. However, the maximum aggregate number of shares that may be issued under the plan may be stated in terms of a percentage of the authorized, issued, or outstanding shares at the date of the adoption of the plan. The plan may specify that the maximum aggregate number of shares available for grants under the

plan may increase annually by a specified percentage of the authorized, issued, or outstanding shares at the date of the adoption of the plan. A plan which provides that the maximum aggregate number of shares that may be issued as incentive stock options under the plan may change based on any other specified circumstances satisfies the requirements of this paragraph (b)(3) only if the stockholders approve an immediately determinable maximum aggregate number of shares that may be issued under the plan in any event.

(iii) It is permissible for the plan to provide that, shares purchasable under the plan may be supplied to the plan through acquisitions of stock on the open market; shares purchased under the plan and forfeited back to the plan; shares surrendered in payment of the exercise price of an option; shares withheld for payment of applicable employment taxes and/or withholding obligations resulting from the exercise of an option.

(iv) If there is more than one plan under which incentive stock options may be granted and stockholders of the granting corporation merely approve a maximum aggregate number of shares that are available for issuance under such plans, the stockholder approval requirements described in paragraph (b)(2) of this section are not satisfied. A separate maximum aggregate number of shares available for issuance pursuant to incentive stock options must be approved for each plan.

(4) Designation of employees. The plan described in this paragraph (b), as adopted and approved, must indicate the employees (or class or classes of employees) eligible to receive the options or other stock-based awards to be granted under the plan. This requirement is satisfied by a general designation of the employees (or the class or

classes of employees) eligible to receive options or other stock-based awards under the plan. Designations such as "key employees of the grantor corporation"; "all salaried employees of the grantor corporation and its subsidiaries, including subsidiaries which become such after adoption of the plan;" or "all employees of the corporation" meet this requirement. This requirement is considered satisfied even though the board of directors, another group, or an individual is given the authority to select the particular employees who are to receive options or other stock-based awards from a described class and to determine the number of shares to be optioned or granted to each such employee. If individuals other than employees may be granted options or other stock-based awards under the plan, the plan must separately designate the employees or classes of employees eligible to receive incentive stock options.

(5) Conflicting option terms. An option on stock available for purchase or grant under the plan is treated as having been granted pursuant to a plan even if the terms of the option conflict with the terms of the plan, unless such option is granted to an employee who is ineligible to receive options under the plan, options have been granted on stock in excess of the aggregate number of shares which may be issued under the plan, or the option provides otherwise.

(6) The following examples illustrate the principles of this paragraph (b):

Example 1. Stockholder approval. (i) S Corporation is a subsidiary of P Corporation, a publicly traded corporation. On January 1, 2006, S adopts a plan under which incentive stock options for S stock are granted to S employees.

(ii) To meet the requirements of paragraph (b)(2) of this section, the plan must be approved by the stockholders of S (in this case, P) within 12 months before or after January 1, 2006.

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

Example 2. Stockholder approval. (i) Assume the same facts as in paragraph (i) of Example 1, except that on March 15, 2007, P completely disposes of its interest in S. Thereafter, S continues to grant options for S stock to S employees under the plan.

(ii) The new S options are granted under a plan that meets the stockholder approval requirements of paragraph (b)(2) of this section without regard to whether S seeks approval of the plan from the stockholders of S after P disposes of its interest in S.

(iii) Assume the same facts as in paragraph (i) of this Example 2, except that under the plan as adopted on January 1, 2006, only options for P stock are granted to S employees. Assume further that after P disposes of its interest in S, S changes the plan to provide for the grant of options for S stock to S employees. Because there is a change in the stock available for purchase or grant under the plan, under paragraph (b)(2)(iii) of this section, the stockholders of S must approve the plan within 12 months before or after the change to the plan to meet the stockholder approval requirements of paragraph (b) of this section.

Example 3. Stockholder approval. (i) Corporation X maintains a plan under which incentive stock options may be granted to all eligible employees. Corporation Y does not maintain an incentive stock option plan. On May 15, 2006, Corporation X and Corporation Y consolidate under state law to form one corporation. The new corporation will be named Corporation Y. The consolidation agreement describes the Corporation X plan, including the maximum aggregate number of shares available for issuance pursuant to incentive stock options after the consolidation and the employees eligible to receive options under the plan. Additionally, the consolidation agreement states that the plan will be continued by Corporation Y after the consolidation and incentive stock options will be issued by Corporation Y. The consolidation agreement is unanimously approved by the shareholders of Corporations X and Y on May 1, 2006. Corporation Y assumes the plan formerly maintained by Corporation X and continues to grant options under the plan to all eligible employees.

(ii) Because there is a change in the granting corporation (from Corporation X to Corporation Y), under paragraph (b)(2)(iii) of this section, Corporation Y is considered to have adopted a new plan. Because the plan is fully described in the consolidation agreement, including the maximum aggregate number of shares available for issuance pursuant to incentive stock options and employees eligible to receive options under the plan, the approval of the consolidation agreement by the shareholders constitutes

approval of the plan. Thus, the shareholder approval of the consolidation agreement satisfies the shareholder approval requirements of paragraph (b)(2) of this section, and the plan is considered to be adopted by Corporation Y and approved by its shareholders on May 1, 2006.

Example 4. Maximum aggregate number of shares. X Corporation maintains a plan under which statutory options and nonstatutory options may be granted. The plan designates the number of shares that may be used for incentive stock options. Because the maximum aggregate number of shares that will be used for incentive stock options is designated in the plan, the requirements of paragraph (b)(3) of this section are satisfied.

Example 5. Maximum aggregate number of shares. Y Corporation adopts an incentive stock option plan on November 1, 2006. On that date, there are two million outstanding shares of Y Corporation stock. The plan provides that the maximum aggregate number of shares that may be issued under the plan may not exceed 15% of the outstanding number of shares of Y Corporation on November 1, 2006. Because the maximum aggregate number of shares that may be issued under the plan is designated in the plan, the requirements of paragraph (b)(3) of this section are met.

Example 6. Maximum aggregate number of shares. (i) B Corporation adopts an incentive stock option plan on March 15, 2005. The plan provides that the maximum aggregate number of shares available for issuance under the plan is 50,000, increased on each anniversary date of the adoption of the plan by 5 percent of the then-outstanding shares.

(ii) Because the maximum aggregate number of shares is not designated under the plan, the requirements of paragraph (b)(3) of this section are not met.

(iii) Assume the same facts as in paragraph (i) of this Example 6, except that the plan provides that the maximum aggregate number of shares available under the plan is the lesser of (a) 50,000 shares, increased each anniversary date of the adoption of the plan by 5 percent of the then-outstanding shares, or (b) 200,000 shares. Because the maximum aggregate number of shares that may be issued under the plan is designated as the lesser of one of two numbers, one of which provides an immediately determinable maximum aggregate number of shares that may be issued under the plan in any event, the requirements of paragraph (b)(3) of this section are met.

(c) Duration of option grants under the plan. An incentive stock option must be granted within 10 years from the date that the plan under which it is granted is adopted or the date such plan is approved by the stockholders, whichever is earlier. To grant

incentive stock options after the expiration of the 10-year period, a new plan must be adopted and approved.

(d) Period for exercising options. An incentive stock option, by its terms, must not be exercisable after the expiration of 10 years from the date such option is granted, or 5 years from the date such option is granted to an employee described in paragraph (f) of this section. An option that does not contain such a provision when granted is not an incentive stock option.

(e) Option price. (1) Except as provided by paragraph (e)(2) of this section, the option price of an incentive stock option must not be less than the fair market value of the stock subject to the option at the time the option is granted. The option price may be determined in any reasonable manner, including the valuation methods permitted under §20.2031-2 of this chapter, so long as the minimum price possible under the terms of the option is not less than the fair market value of the stock on the date of grant. For general rules relating to the option price, see §1.421-1(e). For rules relating to the determination of when an option is granted, see §1.421-1(c).

(2)(i) If a share of stock is transferred to an individual pursuant to the exercise of an option which fails to qualify as an incentive stock option merely because there was a failure of an attempt, made in good faith, to meet the option price requirements of paragraph (e)(1) of this section, the requirements of such paragraph are considered to have been met. Whether there was a good-faith attempt to set the option price at not less than the fair market value of the stock subject to the option at the time the option was granted depends on the relevant facts and circumstances.

(ii) For publicly held stock that is actively traded on an established market at the time the option is granted, determining the fair market value of such stock by the appropriate method described in §20.2031-2 of this chapter establishes that a good-faith attempt to meet the option price requirements of this paragraph (e) was made.

(iii) For non-publicly traded stock, if it is demonstrated, for example, that the fair market value of the stock at the date of grant was based upon an average of the fair market values as of such date set forth in the opinions of completely independent and well-qualified experts, such a demonstration generally establishes that there was a good-faith attempt to meet the option price requirements of this paragraph (e). The optionee's status as a majority or minority stockholder may be taken into consideration.

(iv) Regardless of whether the stock offered under an option is publicly traded, a good-faith attempt to meet the option price requirements of this paragraph (e) is not demonstrated unless the fair market value of the stock on the date of grant is determined with regard to nonlapse restrictions (as defined in §1.83-3(h)) and without regard to lapse restrictions (as defined in §1.83-3(i)).

(v) Amounts treated as interest and amounts paid as interest under a deferred payment arrangement are not includible as part of the option price. See §1.421-1(e)(1). An attempt to set the option price at not less than fair market value is not regarded as made in good faith where an adjustment of the option price to reflect amounts treated as interest results in the option price being lower than the fair market value on which the option price was based.

(3) Notwithstanding that the option price requirements of paragraphs (e)(1) and (2) of this section are satisfied by an option granted to an employee whose stock

ownership exceeds the limitation provided by paragraph (f) of this section, such option is not an incentive stock option when granted unless it also complies with paragraph (f) of this section. If the option, when granted, does not comply with the requirements described in paragraph (f) of this section, such option can never become an incentive stock option, even if the employee's stock ownership does not exceed the limitation of paragraph (f) of this section when such option is exercised.

(f) Options granted to certain stockholders. (1) If, immediately before an option is granted, an individual owns (or is treated as owning) stock possessing more than 10 percent of the total combined voting power of all classes of stock of the corporation employing the optionee or of any related corporation of such corporation, then an option granted to such individual cannot qualify as an incentive stock option unless the option price is at least 110 percent of the stock's fair market value on the date of grant and such option by its terms is not exercisable after the expiration of 5 years from the date of grant. For purposes of determining the minimum option price for purposes of this paragraph (f), the rules described in paragraph (e)(2) of this section, relating to the good-faith determination of the option price, do not apply.

(2) For purposes of determining the stock ownership of the optionee, the stock attribution rules of §1.424-1(d) apply. Stock that the optionee may purchase under outstanding options is not treated as stock owned by the individual. The determination of the percentage of the total combined voting power of all classes of stock of the employer corporation (or of its related corporations) that is owned by the optionee is made with respect to each such corporation in the related group by comparing the voting power of the shares owned (or treated as owned) by the optionee to the

aggregate voting power of all shares of each such corporation actually issued and outstanding immediately before the grant of the option to the optionee. The aggregate voting power of all shares actually issued and outstanding immediately before the grant of the option does not include the voting power of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

(3) Examples. The rules of this paragraph (f) are illustrated by the following examples:

Example 1. (i) E, an employee of M Corporation, owns 15,000 shares of M Corporation common stock, which is the only class of stock outstanding. M has 100,000 shares of its common stock outstanding. On January 1, 2005, when the fair market value of M stock is $100, E is granted an option with an option price of $100 and an exercise period of 10 years from the date of grant.

(ii) Because E owns stock possessing more than 10 percent of the total combined voting power of all classes of M Corporation stock, M cannot grant an incentive stock option to E unless the option is granted at an option price of at least 110 percent of the fair market value of the stock subject to the option and the option, by its terms, expires no later than 5 years from its date of grant. The option granted to E fails to meet the option-price and term requirements described in paragraph (f)(1) of this section and, thus, the option is not an incentive stock option.

(iii) Assume the same facts as in paragraph (i) of this Example 1, except that E's father and brother each owns 7,500 shares of M Corporation stock, and E owns no M stock in E's own name. Because under the attribution rules of §1.424-1(d), E is treated as owning stock held by E's parents and siblings, M cannot grant an incentive stock option to E unless the option price is at least 110 percent of the fair market value of the stock subject to the option, and the option, by its terms, expires no later than 5 years from the date of grant.

Example 2. Assume the same facts as in paragraph (i) of this Example 1. Assume further that M is a subsidiary of P Corporation. Regardless of whether E owns any P stock and the number of P shares outstanding, if P Corporation grants an option to E which purports to be an incentive stock option, but which fails to meet the 110-percent-option-price and 5-year-term requirements, the option is not an incentive stock option because E owns more than 10 percent of the total combined voting power of all classes of stock of a related corporation of P Corporation (i.e., M Corporation). An individual who owns (or is treated as owning) stock in excess of the ownership specified in paragraph (f)(1) of this section, in any corporation in a group of corporations

consisting of the employer corporation and its related corporations, cannot be granted an incentive stock option by any corporation in the group unless such option meets the 110-percent-option-price and 5-year-term requirements of paragraph (f)(1) of this section.

Example 3. (i) F is an employee of R Corporation. R has only one class of stock, of which 100,000 shares are issued and outstanding. F owns no stock in R Corporation or any related corporation of R Corporation. On January 1, 2005, R grants a 10-year incentive stock option to F to purchase 50,000 shares of R stock at $3 per share, the fair market value of R stock on the date of grant of the option. On April 1, 2005, F exercises half of the January option and receives 25,000 shares of R stock that previously were not outstanding. On July 1, 2005, R grants a second 50,000 share option to F which purports to be an incentive stock option. The terms of the July option are identical to the terms of the January option, except that the option price is $3.25 per share, which is the fair market value of R stock on the date of grant of the July option.

(ii) Because F does not own more than 10% of the total combined voting power of all classes of stock of R Corporation or any related corporation on the date of the grant of the January option and the pricing requirements of paragraph (e) of this section are satisfied on the date of grant of such option, the unexercised portion of the January option remains an incentive stock option regardless of the changes in F's percentage of stock ownership in R after the date of grant. However, the July option is not an incentive stock option because, on the date that it is granted, F owns 20 percent (25,000 shares owned by F divided by 125,000 shares of R stock issued and outstanding) of the total combined voting power of all classes of R Corporation stock and, thus the pricing requirements of paragraph (f)(1) of this section are not met.

(iii) Assume the same facts as in paragraph (i) of this Example 3 except that the partial exercise of the January incentive stock option on April 1, 2003, is for only 10,000 shares. Under these circumstances, the July option is an incentive stock option, because, on the date of grant of the July option, F does not own more than 10 percent of the total combined voting power (10,000 shares owned by F divided by 110,000 shares of R issued and outstanding) of all classes of R Corporation stock.

§1.422-4 [Removed]

Par. 7. Section 1.422-4 is removed.

§1.422-5 [Redesignated as §1.422-3]

Par. 8. Section 1.422-5 is re-designated as §1.422-3.

Par. 9. New §1.422-4 is added to read as follows:

§1.422-4 $100,000 limitation for incentive stock options.

(a) $100,000 per year limitation--(1) General rule. An option that otherwise qualifies as an incentive stock option nevertheless fails to be an incentive stock option to the extent that the $100,000 limitation described in paragraph (a)(2) of this section is exceeded.

(2) $100,000 per year limitation. To the extent that the aggregate fair market value of stock with respect to which an incentive stock option (determined without regard to this section) is exercisable for the first time by any individual during any calendar year (under all plans of the employer corporation and related corporations) exceeds $100,000, such option is treated as a nonstatutory option. See §1.83-7 for rules applicable to nonstatutory options.

(b) Application. To determine whether the limitation described in paragraph (a)(2) of this section has been exceeded, the following rules apply:

(1) An option that does not meet the requirements of §1.422-2 when granted (including an option which, when granted, contains terms providing that it will not be treated as an incentive stock option) is disregarded. See §1.422-2(a)(4).

(2) The fair market value of stock is determined as of the date of grant of the option for such stock.

(3) Except as otherwise provided in paragraph (b)(4) of this section, options are taken into account in the order in which they are granted.

(4) For purposes of this section, an option is considered to be first exercisable during a calendar year if the option will become exercisable at any time during the year assuming that any condition on the optionee's ability to exercise the option related to the performance of services is satisfied. If the optionee's ability to exercise the option ir

the year is subject to an acceleration provision, then the option is considered first exercisable in the calendar year in which the acceleration provision is triggered. After an acceleration provision is triggered, the options subject to such provision are then taken into account in accordance with paragraph (b)(3) of this section for purposes of applying the limitation described in paragraph (a)(2) of this section to all options first exercisable during a calendar year. However, because an acceleration provision is not taken into account prior to its triggering, an incentive stock option that becomes exercisable for the first time during a calendar year by operation of such a provision does not affect the application of the $100,000 limitation with respect to any option (or portion thereof) exercised prior to such acceleration. For purposes of this paragraph (b)(4), an acceleration provision includes, for example, a provision that accelerates the exercisability of an option on a change in ownership or control or a provision that conditions exercisability on the attainment of a performance goal. See paragraph (d), Example 4 of this section.

(5)(i) An option (or portion thereof) is disregarded if, prior to the calendar year during which it would otherwise have become exercisable for the first time, the option (or portion thereof) is modified and thereafter ceases to be an incentive stock option described in §1.422-2, is canceled, or is transferred in violation of §1.421-1(b)(2).

(ii) If an option (or portion thereof) is modified, canceled, or transferred at any other time, such option (or portion thereof) is treated as outstanding according to its original terms until the end of the calendar year during which it would otherwise have become exercisable for the first time.

(6) A disqualifying disposition has no effect on the determination of whether an option exceeds the $100,000 limitation.

(c) Bifurcation-- (1) Options. The application of the rules described in paragraph (b) of this section may result in an option being treated, in part, as an incentive stock option and, in part, as a nonstatutory option. See §1.83-7 for the treatment of nonstatutory options.

(2) Stock. A corporation may issue a separate certificate for incentive option stock or designate such stock as incentive stock option stock in the corporation's transfer records or plan records. In such a case, the issuance of separate certificates or designation in the corporation's transfer records or plan records is not a modification under §1.424-1(e). In the absence of such an issuance or designation, shares are treated as first purchased under an incentive stock option to the extent of the $100,000 limitation, and the excess shares are treated as purchased under a nonstatutory option. See §1.83-7 for the treatment of nonstatutory options.

(d) Examples. The following examples illustrate the principles of this section. In each of the following examples E is an employee of X Corporation. The examples are as follows:

Example 1. General rule. Effective January 1, 2004, X Corporation adopts a plan under which incentive stock options may be granted to its employees. On January 1, 2004, and each succeeding January 1 through January 1, 2013, E is granted immediately exercisable options for X Corporation stock with a fair market value of $100,000 determined on the date of grant. The options qualify as incentive stock options (determined without regard to this section). On January 1, 2014, E exercises all of the options. Because the $100,000 limitation has not been exceeded during any calendar year, all of the options are treated as incentive stock options.

Example 2. Order of grant. X Corporation is a parent corporation of Y Corporation, which is a parent corporation of Z Corporation. Each corporation has

adopted its own separate plan, under which an employee of any member of the corporate group may be granted options for stock of any member of the group. On January 1, 2004, X Corporation grants E an incentive stock option (determined without regard to this section) for stock of Y Corporation with a fair market value of $100,000 on the date of grant. On December 31, 2004, Y Corporation grants E an incentive stock option (determined without regard to this section) for stock of Z Corporation with a fair market value of $75,000 as of the date of grant. Both of the options are immediately exercisable. For purposes of this section, options are taken into account in the order in which granted using the fair market value of stock as of the date on the option is granted. During calendar year 2004, the aggregate fair market value of stock with respect to which E's options are exercisable for the first time exceeds $100,000. Therefore, the option for Y Corporation stock is treated as an incentive stock option, and the option for Z Corporation stock is treated as a nonstatutory option.

Example 3. Acceleration provision. (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of $150,000 on the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of Grant	Fair Market Value of Stock	First Exercisable
Option 1	April 1, 2004	$60,000	2004
Option 2	May 1, 2004	$50,000	2006
Option 3	June 1, 2004	$40,000	2004

(ii) In July of 2004, a change in control of X Corporation occurs, and, under the terms of its option plan, all outstanding options become immediately exercisable. Under the rules of this section, Option 1 is treated as an incentive stock option in its entirety; Option 2 exceeds the $100,000 aggregate fair market value limitation for calendar year 2004 by $10,000 (Option 1's $60,000 + Option 2's $50,000 = $110,000) and is, therefore, bifurcated into an incentive stock option for stock with a fair market value of $40,000 as of the date of grant and a nonstatutory option for stock with a fair market value of $10,000 as of the date of grant. Option 3 is treated as a nonstatutory option in its entirety.

Example 4. Exercise of option and acceleration provision. (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of $120,000 on the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of

grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of Grant	Fair Market Value of Stock	First Exercisable
Option 1	April 1, 2004	$60,000	2005
Option 2	May 1, 2004	$40,000	2006
Option 3	June 1, 2004	$20,000	2005

(ii) On June 1, 2005, E exercises Option 3. At the time of exercise of Option 3, the fair market value of X stock (at the time of grant) with respect to which options held by E are first exercisable in 2005 does not exceed $100,000. On September 1, 2005, a change of control of X Corporation occurs, and, under the terms of its option plan, Option 2 becomes immediately exercisable. Under the rules of this section, because E's exercise of Option 3 occurs before the change of control and the effects of an acceleration provision are not taken into account until it is triggered, Option 3 is treated as an incentive stock option in its entirety. Option 1 is treated as an incentive stock option in its entirety. Option 2 is bifurcated into an incentive stock option for stock with a fair market value of $20,000 on the date of grant and a nonstatutory option for stock with a fair market value of $20,000 on the date of grant because it exceeds the $100,000 limitation for 2003 by $20,000 (Option 1 for $60,000 + Option 3 for $20,000 + Option 2 for $40,000 = $120,000).

(iii) Assume the same facts as in paragraph (ii) of this Example 4, except that the change of control occurs on May 1, 2005. Because options are taken into account in the order in which they are granted, Option 1 and Option 2 are treated as incentive stock options in their entirety. Because the exercise of Option 3 (on June 1, 2005) takes place after the acceleration provision is triggered, Option 3 is treated as a nonstatutory option in its entirety.

Example 5. Cancellation of option. (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of $140,000 as of the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of Grant	Fair Market Value of Stock	First Exercisable
Option 1	April 1, 2004	$60,000	2005
Option 2	May 1, 2004	$40,000	2005
Option 3	June 1, 2004	$40,000	2005

(ii) On December 31, 2004, Option 2 is canceled. Because Option 2 is canceled before the calendar year during which it would have become exercisable for the first time, it is disregarded. As a result, Option 1 and Option 3 are treated as incentive stock options in their entirety.

(iii) Assume the same facts as in paragraph (ii) of this Example 5, except that Option 2 is canceled on January 1, 2005. Because Option 2 is not canceled prior to the calendar year during which it would have become exercisable for the first time (2005), it is treated as an outstanding option for purposes of determining whether the $100,000 limitation for 2005 has been exceeded. Because options are taken into account in the order in which granted, Option 1 is treated as an incentive stock option in its entirety. Because Option 3 exceeds the $100,000 limitation by $40,000 (Option 1 for $60,000 + Option 2 for $40,000 + Option 3 for $40,000 = $140,000), it is treated as a nonstatutory options in its entirety.

(iv) Assume the same facts as in paragraph (i) of this Example 5, except that on January 1, 2005, E exercises Option 2 and immediately sells the stock in a disqualifying disposition. A disqualifying disposition has no effect on the determination of whether the underlying option is considered outstanding during the calendar year during which it is first exercisable. Because options are taken into account in the order in which granted, Option 1 is treated as an incentive stock option in its entirety. Because Option 3 exceeds the $100,000 limitation by $40,000 (Option 1 for $60,000 + Option 2 for $40,000 + Option 3 for $40,000 = $140,000), it is treated as a nonstatutory option in its entirety.

Example 6. Designation of stock. On January 1, 2004, X grants E an immediately exercisable incentive stock option (determined without regard to this section) to acquire X stock with a fair market value of $150,000 on that date. Under the rules of this section, the option is bifurcated and treated as an incentive stock option for

X stock with a fair market value of $100,000 and a nonstatutory option for X stock with a fair market value of $50,000. In these circumstances, X may designate the stock that is treated as stock acquired pursuant to the exercise of an incentive stock option by issuing a separate certificate (or certificates) for $100,000 of stock and identifying such certificates as Incentive Stock Option Stock in its transfer records. In the absence of such a designation (or a designation in the corporation's transfer records or the plan records) shares with a fair market value of $100,000 are deemed purchased first under an incentive stock option, and shares with a fair market value of $50,000 are deemed purchased under a nonstatutory option.

Par. 10. Section 1.422-5 is added to read as follows:

§1.422-5 Permissible provisions.

(a) General rule. An option that otherwise qualifies as an incentive stock option does not fail to be an incentive stock option merely because such option contains one or more of the provisions described in paragraphs (b), (c), and (d) of this section.

(b) Cashless exercise. (1) An option does not fail to be an incentive stock option merely because the optionee may exercise the option with previously acquired stock of the corporation that granted the option or stock of the corporation whose stock is being offered for purchase under the option. For special rules relating to the use of statutory option stock to pay the option price of an incentive stock option, see §1.424-1(c)(3).

(2) All shares acquired through the exercise of an incentive stock option are individually subject to the holding period requirements described in §1.422-1(a) and the disqualifying disposition rules of §1.422-1(b), regardless of whether the option is exercised with previously acquired stock of the corporation that granted the option or stock of the corporation whose stock is being offered for purchase under the option. If an incentive stock option is exercised with such shares, and the exercise results in the basis allocation described in paragraph (b)(3) of this section, the optionee's

disqualifying disposition of any of the stock acquired through such exercise is treated as a disqualifying disposition of the shares with the lowest basis.

(3) If the exercise of an incentive stock option with previously acquired shares is comprised in part of an exchange to which section 1036 (and so much of section 1031 as relates to section 1036) applies, then:

(i) The optionee's basis in the incentive stock option shares received in the section 1036 exchange is the same as the optionee's basis in the shares surrendered in the exchange, increased, if applicable, by any amount included in gross income as compensation pursuant to sections 421 through 424 or section 83. Except for purposes of §1.422-1(a), the holding period of the shares is determined under section 1223. For purposes of §1.422-1 and sections 421(b) and 83 and the regulations thereunder, the amount paid for the shares purchased under the option is the fair market value of the shares surrendered on the date of the exchange.

(ii) The optionee's basis in the incentive stock option shares not received pursuant to the section 1036 exchange is zero. For all purposes, the holding period of such shares begins as of the date that such shares are transferred to the optionee. For purposes of §1.422-1(b) and sections 421(b) and 83 and the regulations thereunder, the amount paid for the shares is considered to be zero.

(c) Additional compensation. An option does not fail to be an incentive stock option merely because the optionee has the right to receive additional compensation, in cash or property, when the option is exercised, provided such additional compensation is includible in income under section 61 or section 83. The amount of such additional

compensation may be determined in any manner, including by reference to the fair market value of the stock at the time of exercise or to the option price.

(d) Option subject to a condition. (1) An option does not fail to be an incentive stock option merely because the option is subject to a condition, or grants a right, that is not inconsistent with the requirements of §§1.422-2 and 1.422-4.

(2) An option that includes an alternative right is not an incentive stock option if the requirements of §1.422-2 are effectively avoided by the exercise of the alternative right. For example, an alternative right extending the option term beyond ten years, setting an option price below fair market value, or permitting transferability prevents an option from qualifying as an incentive stock option. If either of two options can be exercised, but not both, each such option is a disqualifying alternative right with respect to the other, even though one or both options would individually satisfy the requirements of §§1.422-2, 1.422-4, and this section.

(3) An alternative right to receive a taxable payment of cash and/or property in exchange for the cancellation or surrender of the option does not disqualify the option as an incentive stock option if the right is exercisable only when the then fair market value of the stock exceeds the exercise price of the option and the option is otherwise exercisable, the right is transferable only when the option is otherwise transferable, and the exercise of the right has economic and tax consequences no more favorable than the exercise of the option followed by an immediate sale of the stock. For this purpose, the exercise of the alternative right does not have the same economic and tax consequences if the payment exceeds the difference between the then fair market value of the stock and the exercise price of the option.

(e) Examples. The principles of this section are illustrated by the following examples:

Example 1. On June 1, 2004, X Corporation grants an incentive stock option to A, an employee of X Corporation, entitling A to purchase 100 shares of X Corporation common stock at $10 per share. The option provides that A may exercise the option with previously acquired shares of X Corporation common stock. X Corporation has only one class of common stock outstanding. Under the rules of section 83, the shares transferable to A through the exercise of the option are transferable and not subject to a substantial risk of forfeiture. On June 1, 2005, when the fair market value of an X Corporation share is $25, A uses 40 shares of X Corporation common stock, which A had purchased on the open market on June 1, 2002, for $5 per share, to pay the full option price. After exercising the option, A owns 100 shares of incentive stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), 40 of the shares have a $200 aggregate carryover basis (the $5 purchase price x 40 shares) and a three-year holding period for purposes of determining capital gain, and 60 of the shares have a zero basis and a holding period beginning on June 1, 2005, for purposes of determining capital gain. All 100 shares have a holding period beginning on June 1, 2005, for purposes of determining whether the holding period requirements of §1.422-1(a) are met.

Example 2. Assume the same facts as in Example 1. Assume further that, on September 1, 2005, A sells 75 of the shares that A acquired through exercise of the incentive stock option for $30 per share. Because the holding period requirements were not satisfied, A made a disqualifying disposition of the 75 shares on September 1, 2005. Under the rules of paragraph (b)(3) of this section, A has sold all 60 of the non-section-1036 shares and 15 of the 40 section-1036 shares. Therefore, under paragraph (b)(3) of this section and section 83(a), the amount of compensation attributable to A's exercise of the option and subsequent disqualifying disposition of 75 shares is $1,500 (the difference between the fair market value of the stock on the date of transfer, $1,875 (75 shares at $25 per share), and the amount paid for the stock, $375 (60 shares at $0 per share plus 15 shares at $25 per share)). In addition, A must recognize a capital gain of $675, which consists of $375 ($450, the amount realized from the sale of 15 shares, less A's basis of $75) plus $300 ($1,800, the amount realized from the sale of 60 shares, less A's basis of $1,500 resulting from the inclusion of that amount in income as compensation). Accordingly, A must include in gross income for the taxable year in which the sale occurs $1,500 as compensation and $675 as capital gain. For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under section 162 and if the requirements of §1.83-6(a) are met, X Corporation is allowed a deduction of $1,500 for the compensation paid to A.

Example 3. Assume the same facts as in Example 2, except that, instead of selling the 75 shares of incentive stock option stock on September 1, 2005, A uses those shares to exercise a second incentive stock option. The second option was

granted to A by X Corporation on January 1, 2005, entitling A to purchase 100 shares of X Corporation common stock at $22.50 per share. As in Example 2, A has made a disqualifying disposition of the 75 shares of stock pursuant to §1.424-1(c). Under paragraph (b) of this section, A has disposed of all 60 of the non-section-1036 shares and 15 of the 40 section-1036 shares. Therefore, pursuant to paragraph (b)(3) of this section and section 83(a), the amount of compensation attributable to A's exercise of the first option and subsequent disqualifying disposition of 75 shares is $1,500 (the difference between the fair market value of the stock on the date of transfer, $1,875 (75 shares at $25 per share), and the amount paid for the stock, $375 (60 shares at $0 per share plus 15 shares at $25 per share)). Unlike Example 2, A does not recognize any capital gain as a result of exercising the second option because, for all purposes other than the determination of whether the exercise is a disposition pursuant to section 424(c), the exercise is considered an exchange to which section 1036 applies. Accordingly, A must include in gross income for the taxable year in which the disqualifying disposition occurs $1,500 as compensation. If the requirements of §83(h) and §1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $1,500 for the compensation paid to A. After exercising the second option, A owns a total of 125 shares of incentive stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), the 100 "new" shares of incentive stock option stock have the following bases and holding periods: 15 shares have a $75 carryover basis and a three-year-and-three-month holding period for purposes of determining capital gain, 60 shares have a $1,500 basis resulting from the inclusion of that amount in income as compensation and a three-month holding period for purposes of determining capital gain, and 25 shares have a zero basis and a holding period beginning on September 1, 2005, for purposes of determining capital gain. All 100 shares have a holding period beginning on September 1, 2005, for purposes of determining whether the holding period requirements of §1.422-1(a) are met.

Example 4. Assume the same facts as in Example 2, except that, instead of selling the 75 shares of incentive stock option stock on September 1, 2005, A uses those shares to exercise a nonstatutory option. The nonstatutory option was granted to A by X Corporation on January 1, 2005, entitling A to purchase 100 shares of X Corporation common stock at $22.50 per share. Unlike Example 3, A has not made a disqualifying disposition of the 75 shares of stock. After exercising the nonstatutory option, A owns a total of 100 shares of incentive stock option stock and 25 shares of nonstatutory stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), the 75 new shares of incentive stock option stock have the same basis and holding period as the 75 old shares used to exercise the nonstatutory option. The additional 25 shares of stock received upon exercise of the nonstatutory option are taxed under the rules of section 83(a). Accordingly, A must include in gross income for the taxable year in which the transfer of such shares occurs $750 (25 shares at $30 per share) as compensation. A's basis in such shares is the same as the amount included in gross income. For its taxable year in which the transfer occurs, X Corporation is allowed a deduction of $750 for the compensation paid to A to the extent

the requirements of section 83(h) and §1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162.

Example 5. Assume the same facts in Example 1, except that the shares transferred pursuant to the exercise of the incentive stock option are subject to a substantial risk of forfeiture and not transferable (substantially no nvested) for a period of six months after such transfer. Assume further that the shares that A uses to exercise the incentive stock option are similarly restricted. Such shares were transferred to A on January 1, 2005, through A's exercise of a nonstatutory stock option which was granted to A on January 1, 2004. A paid $5 per share for the stock when its fair market value was $22.50 per share. A did not file a section 83(b) election to include the $700 spread (the difference between the option price and the fair market value of the stock on date of exercise of the nonstatutory option) in gross income as compensation. After exercising the incentive stock option with the 40 substantially-nonvested shares, A owns 100 shares of substantially-nonvested incentive stock option stock. Section 1036 (and so much of section 1031 as relates to section 1036) applies to the 40 shares exchanged in exercise of the incentive stock option. However, pursuant to section 83(g), the stock received in such exchange, because it is incentive stock option stock, is not subject to restrictions and conditions substantially similar to those to which the stock given in such exchange was subject. For purposes of section 83(a) and §1.83-1(b)(1), therefore, A has disposed of the 40 shares of substantially-nonvested stock on June 1, 2005, and must include in gross income as compensation $800 (the difference between the amount realized upon such disposition, $1,000, and the amount paid for the stock, $200). Accordingly, 40 shares of the incentive stock option stock have a $1,000 basis (the $200 original basis plus the $800 included in income as compensation) and 60 shares of the incentive stock option stock have a zero basis. For its taxable year in which the disposition of the substantially-nonvested stock occurs, X Corporation is allowed a deduction of $800 for the compensation paid to A, provided the requirements of section 83(h) and §1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162.

(f) Effective date-- (1) In general. These regulations are effective on August 3, 2004.

(2) Reliance and transition period. For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR-279-81 (49 FR 4504), the 2003 proposed regulations REG-122917-02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory

options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004, taxpayers may rely on either the REG-122917-02 or this section. Taxpayers may not rely on LR-279-81 or REG-122917-02 after December 31, 2005. Reliance on LR-279-81, REG-122917-02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

§1.423-1 [Amended]

Par. 11. Section 1.423-1 is amended as follows:

1. In paragraph (a)(2), the language "425(a)" is removed and "424(a)" is added in its place.

2. In paragraph (b), first sentence, the language "§1.421-7" is removed and "§1.421-1" is added in its place.

3. In paragraph (b), second sentence, the language "§1.421-8" is removed and §1.421-2" is added in its place.

4. In paragraph (b), last sentence, the language "425(c)" is removed and "424(c)" is added in its place.

5. In paragraph (b), last sentence, the language "§1.425-1" is removed and "§1.424-1" is added in its place.

§1.423-2 [Amended]

Par. 12. Section 1.423-2 is amended by:

1. In paragraph (b), last sentence, the language "§1.421-7" is removed and "§1.421-1" is added in its place.

2. In paragraph (d)(1), second sentence, the language "425(d)" is removed and "424(d)" is added in its place.

3. In paragraph (d)(3), Example 1, fourth sentence, the language "425(d)" is removed and "424(d)" is added in its place.

4. In paragraph (e)(2), the language "§1.421-7" is removed and "§1.421-1" is added in its place.

5. In paragraph (g)(1), the first sentence of the concluding text, the language "§1.421-7" is removed and "§1.421-1" is added in its place.

6. In paragraph (g)(1), the second sentence of the concluding text, the language "§1.421-7" is removed and "§1.421-1" is added in its place.

7. In paragraph (j), second sentence, the language "§1.421-7" is removed and "§1.421-1" is added in its place.

8. In paragraph (j), last sentence, the language "425" is removed and "424" is added in its place.

9. In paragraph (k)(2), second sentence, the language "§1.421-8" is removed and "§1.421-2" is added in its place.

§1.425-1 [Redesignated as §1.424-1]

Par. 13. Section 1.425-1 is redesignated as §1.424-1 and is amended by:

1. Revising paragraphs (a)(1) through (a)(6).

2. Redesignating paragraph (a)(7) as paragraph (a)(9).

3. Adding a new paragraph (a)(7).

4. Revising paragraph (a)(8).

5. Adding paragraph (a)(10).

6. In paragraph (b)(1), first, second, and last sentences, the language "425" is removed wherever it appears, and "424" is added in their places.

7. In paragraph (c)(1), first sentence, the language "425" is removed and "424" is added in its place.

8. In paragraph (c)(1), first sentence, the language "disposition" is removed and "disposition of stock" is added in its place.

9. Adding paragraph (c)(1)(iv).

10. Redesignating paragraph (c)(3) as (c)(4).

11. Adding new paragraph (c)(3).

12. Adding newly designated paragraph (c)(4) Examples 7 through 9.

13. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	Remove	Add
1.424-1(c)(4) Example 1, first sentence	1964	2004
1.424-1(c)(4) Example 1, first sentence	qualified stock option	statutory option
1.424-1(c)(4) Example 1, second and fourth sentences	1965	2005
1.424-1(c)(4) Example 1, third sentence	1968	2006

1.424-1(c)(4) Example 2, first sentence	1968	2006
1.424-1(c)(4) Example 2, last sentence	long-term	
1.424-1(c)(4) Example 3, first sentence	1968	2006
1.424-1(c)(4) Example 4, first sentence	1968, two years and 11 months after the transfer of shares to him	2006
1.424-1(c)(4) Example 4, last sentence	three years from the date	two years from the date the options were granted and within one year of the date that
1.424-1(c)(4) Example 5, first sentence	1965	2005
1.424-1(c)(4) Example 5, first sentence	qualified stock option	statutory option
1.424-1(c)(4) Example 6, first sentence	1965	2005
1.424-1(c)(4) Example 6, third sentence	three years	2 years
1.424-1(c)(4) Example 6, third sentence	income	compensation income
1.424-1(c)(4) Example 6, third sentence	a qualified stock option	the option
1.424-1(c)(4) Example 6, last sentence	paragraph (b)(2) of §1.421-8	§1.421-2(b)(2)

14. Revising paragraph (d).

15. Revising paragraphs (e)(1) and (e)(2).

16. In paragraph (e)(3), first sentence, remove the phrase "Except as otherwise provided in subparagraph (4) of this paragraph" and add "If section 423(c) applies to an option then,".

17. In paragraph (e)(3), first sentence, remove the language ", and 424(b)(1)."

18. Removing paragraph (e)(4).

19. Redesignating paragraph (e)(5) as paragraph (e)(4).

20. Revising newly designated paragraph (e)(4).

21. Redesignating paragraph (e)(6) as paragraph (e)(5) and removing the second and third sentences.

22. Adding and reserving a new paragraph (e)(6).

23. In list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Section	Remove	Add
1.424-1(e)(7) Example 1, first and sixth sentences	1964	2004
1.424-1(e)(7) Example 1, first sentence	1966	2006
1.424-1(e)(7) Example 1, third, fourth, fifth, sixth and last sentences	1965	2005
1.424-1(e)(7) Example 1, fifth sentence	425(h)	424(h)
1.424-1(e)(7) Example 1, last sentence	The exercise of such	Because the requirements of §1.424-1(e)(3) and §1.423-2(g) have not been met, the exercise of such

1.424-1(e)(7) Example 2, first, second, and fifth sentences	1964	2004
1.424-1(e)(7) Example 2, first, third, fourth, and fifth sentences, wherever it appears	1965	2005
1.424-1(e)(7) Example 2, first and third sentences	1966	2006
1.424-1(e)(7) Example 2, fifth sentence	425(h)	424(h)
1.424-1(e)(7) Example 2, last sentence	The exercise of such	Because the requirements of §1.424-1(e)(3) and §1.423-2(g) have not been met, the exercise of such
1.424-1(e)(7) Example 3, first, second, and last sentences	1965	2005

24. In paragraph (e)(7), remove Example 4.

25. Adding paragraphs (f) and (g).

The additions and revisions are as follows:

§ 1.424-1 Definitions and special rules applicable to statutory options.

(a) Substitutions and assumptions of options--(1) In general. (i) This paragraph (a) provides rules under which an eligible corporation (as defined in paragraph (a)(2) of this section) may, by reason of a corporate transaction (as defined in paragraph (a)(3) of this section), substitute a new statutory option (new option) for an outstanding statutory option (old option) or assume an old option without such substitution or assumption being considered a modification of the old option. For the definition of modification, see paragraph (e) of this section.

(ii) For purposes of §§1.421-1 through 1.424-1, the phrase "substituting or assuming a stock option in a transaction to which section 424 applies," "substituting or assuming a stock option in a transaction to which §1.424-1(a) applies," and similar phrases means a substitution of a new option for an old option or an assumption of an old option that meets the requirements of this paragraph (a). For a substitution or assumption to qualify under this paragraph (a), the substitution or assumption must meet all of the requirements described in paragraphs (a)(4) and (a)(5) of this section.

(2) Eligible corporation. For purposes of this paragraph (a), the term eligible corporation means a corporation that is the employer of the optionee or a related corporation of such corporation. For purposes of this paragraph (a), the determination of whether a corporation is the employer of the optionee or a related corporation of such corporation is based upon all of the relevant facts and

circumstances existing immediately after the corporate transaction. See §1.421-1(h) for rules concerning the employment relationship.

(3) Corporate transaction. For purposes of this paragraph (a), the term corporate transaction includes--

(i) A corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation;

(ii) A distribution (excluding an ordinary dividend or a stock split or stock dividend described in §1.424-1(e)(v)) or change in the terms or number of outstanding shares of such corporation; and

(iii) Such other corporate events prescribed by the Commissioner in published guidance.

(4) By reason of. (i) For a change in an option or issuance of a new option to qualify as a substitution or assumption under this paragraph (a), the change must be made by an eligible corporation (as defined in paragraph (a)(2) of this section) and occur by reason of a corporate transaction (as defined in paragraph (a)(3) of this section).

(ii) Generally, a change in an option or issuance of a new option is considered to be by reason of a corporate transaction, unless the relevant facts and circumstances demonstrate that such change or issuance is made for reasons unrelated to such corporate transaction. For example, a change in an option or issuance of a new option will be considered to be made for reasons unrelated to a corporate transaction if there is an unreasonable delay between the corporate transaction and such change in the option or issuance of a new option, or if the corporate transaction serves no substantial

corporate business purpose independent of the change in options. Similarly, a change in the number or price of shares purchasable under an option merely to reflect market fluctuations in the price of the stock purchasable under an option is not by reason of a corporate transaction.

(iii) A change in an option or issuance of a new option is by reason of a distribution or change in the terms or number of the outstanding shares of a corporation (as described in paragraph (a)(3)(ii) of this section) only if the option as changed, or the new option issued, is an option on the same stock as under the old option (or if such class of stock is eliminated in the change in capital structure, on other stock of the same corporation).

(5) Other requirements. For a change in an option or issuance of a new option to qualify as a substitution or assumption under this paragraph (a), all of the requirements described in this paragraph (a)(5) must be met.

(i) In the case of an issuance of a new option (or a portion thereof) in exchange for an old option (or portion thereof), the optionee's rights under the old option (or portion thereof) must be canceled, and the optionee must lose all rights under the old option (or portion thereof). There cannot be a substitution of a new option for an old option within the meaning of this paragraph (a) if the optionee may exercise both the old option and the new option. It is not necessary to have a complete substitution of a new option for the old option. However, any portion of such option which is not substituted or assumed in a transaction to which this paragraph (a) applies is an outstanding option to purchase stock or, to the extent paragraph (e) of this section applies, a modified option.

(ii) The excess of the aggregate fair market value of the shares subject to the new or assumed option immediately after the change in the option or issuance of a new option over the aggregate option price of such shares must not exceed the excess of the aggregate fair market value of all shares subject to the old option (or portion thereof) immediately before the change in the option or issuance of a new option over the aggregate option price of such shares.

(iii) On a share by share comparison, the ratio of the option price to the fair market value of the shares subject to the option immediately after the change in the option or issuance of a new option must not be more favorable to the optionee than the ratio of the option price to the fair market value of the stock subject to the old option (or portion thereof) immediately before the change in the option or issuance of a new option. The number of shares subject to the new or assumed option may be adjusted to compensate for any change in the aggregate spread between the aggregate option price and the aggregate fair market value of the shares subject to the option immediately after the change in the option or issuance of the new option as compared to the aggregate spread between the option price and the aggregate fair market value of the shares subject to the option immediately before the change in the option or issuance of the new option.

(iv) The new or assumed option must contain all terms of the old option, except to the extent such terms are rendered inoperative by reason of the corporate transaction.

(v) The new option or assumed option must not give the optionee additional benefits that the optionee did not have under the old option.

(6) Obligation to substitute or assume not necessary. For a change in the option or issuance of a new option to meet the requirements of this paragraph (a), it is not necessary to show that the corporation changing an option or issuing a new option is under any obligation to do so. In fact, this paragraph (a) may apply even when the option that is being replaced or assumed expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, this paragraph (a) cannot be applied to revive a statutory option which, for reasons not related to the corporate transaction, expires before it can properly be replaced or assumed under this paragraph (a).

(7) Issuance of stock without meeting the requirements of this paragraph (a). A change in the terms of an option resulting in a modification of such option occurs if an optionee's new employer (or a related corporation of the new employer) issues its stock (or stock of a related corporation) upon exercise of such option without satisfying all of the requirements described in paragraphs (a)(4) and (5) of this section.

(8) Date of grant. For purposes of applying the rules of this paragraph (a), a substitution or assumption is considered to occur on the date that the optionee would, but for this paragraph (a), be considered to have been granted the option that the eligible corporation is substituting or assuming. A substitution or an assumption that occurs by reason of a corporate transaction may occur before or after the corporate transaction.

* * * * *

(10) Examples. The principles of this paragraph (a) are illustrated by the following examples:

Example 1. Eligible corporation. X Corporation acquires a new subsidiary, Y Corporation, and transfers some of its employees to Y. Y Corporation wishes to grant to its new employees and to the employees of X Corporation new options for Y shares in exchange for old options for X shares that were previously granted by X Corporation. Because Y Corporation is an employer with respect to its own employees and a related corporation of X Corporation, Y Corporation is an eligible corporation under paragraph (a)(2) of this section with respect to both the employees of X and Y Corporations.

Example 2. Corporate transaction. (i) On January 1, 2004, Z Corporation grants E, an employee of Z, an option to acquire 100 shares of Z common stock. At the time of grant, the fair market value of Z common stock is $200 per share. E's option price is $200 per share. On July 1, 2005, when the fair market value of Z common stock is $400, Z declares a stock dividend of preferred stock distributed on common stock that causes the fair market value of Z common stock to decrease to $200 per share. On the same day, Z grants to E a new option to acquire 200 shares of Z common stock in exchange for E's old option. The new option has an exercise price of $100 per share.

(ii) A stock dividend other than that described in §1.424-1(e)(4)(v) is a corporate transaction under paragraph (a)(3)(ii) of this section. Generally, the issuance of a new option is considered to be by reason of a corporate transaction. None of the facts in this Example 2 indicate that the new option is not issued by reason of the stock dividend. In addition, the new option is issued on the same stock as the old option. Thus, the substitution occurs by reason of the corporate transaction. Assuming the other requirements of this section are met, the issuance of the new option is a substitution that meets the requirements of this paragraph (a) and is not a modification of the option.

(iii) Assume the same facts as in paragraph (i) of this Example 2. Assume further that on December 1, 2005, Z declares an ordinary cash dividend. On the same day, Z grants E a new option to acquire Z stock in substitution for E's old option. Under paragraph (a)(3)(ii) of this section, an ordinary cash dividend is not a corporate transaction. Thus, the exchange of the new option for the old option does not meet the requirements of this paragraph (a) and is a modification of the option.

Example 3. Corporate transaction. On March 15, 2004, A Corporation grants E, an employee of A, an option to acquire 100 shares of A stock at $50 per share, the fair market value of A stock on the date of grant. On May 2, 2005, A Corporation transfers several employees, including E, to B Corporation, a related corporation. B Corporation arranges to purchase some assets from A on the same day as E's transfer to B. Such purchase is without a substantial business purpose independent of making the exchange of E's old options for the new options appear to be by reason of a corporate transaction. The following day, B Corporation grants to E, one of its new employees, an option to acquire shares of B stock in exchange for the old option held by E to acquire A stock. Under paragraph (a)(3)(i) of this section, the purchase of assets is a corporate transaction. Generally, the substitution of an option is considered to occur by reason of a corporate transaction. However, in this case, the relevant facts and circumstances

demonstrate that the issuance of the new option in exchange for the old option occurred by reason of the change in E's employer rather than a corporate transaction and that the sale of assets is without a substantial corporate business purpose independent of the change in the options. Thus, the exchange of the new option for the old option is not by reason of a corporate transaction that meets the requirements of this paragraph (a) and is a modification of the old option.

Example 4. Corporate transaction. (i) E, an employee of Corporation A, holds an option to acquire 100 shares of Corporation A stock. On September 1, 2006, Corporation A has one class of stock outstanding and declares a stock dividend of one share of common stock for each outstanding share of common stock. The rights associated with the common stock issued as a dividend are the same as the rights under existing shares of stock. In connection with the stock dividend, E's option is exchanged for an option to acquire 200 shares of Corporation A stock. The per-share exercise price is equal to one half of the per-share exercise price of the original option. The stock dividend merely changes the number of shares of Corporation A outstanding and effects no other change to the stock of Corporation A. The option is proportionally adjusted and the aggregate exercise price remains the same and therefore satisfies the requirements described in §1.424-1(e)(4)(v).

(ii) The stock dividend is not a corporate transaction under paragraph (a)(3) of this section, and the declaration of the stock dividend is not a modification of the old option under paragraph (a) of this section. Pursuant to §1.424-1(e)(4)(v), the exercise price of the old option may be adjusted proportionally with the change in the number of outstanding shares of Corporation A such that the ratio of the aggregate exercise price of the option to the number of shares covered by the option is the same both before and after the stock dividend. The adjustment of E's option is not treated as a modification of the option.

Example 5. Additional benefit. On June 1, 2004, P Corporation acquires 100 percent of the shares of S Corporation and issues a new option to purchase P shares in exchange for an old option to purchase S shares that is held by E, an employee of S. On the date of the exchange, E's old option is exercisable for 3 more years, and, after the exchange, E's new option is exercisable for 5 years. Because the new option is exercisable for an additional period of time beyond the time allowed under the old option, the effect of the exchange of the new option for the old option is to give E an additional benefit that E did not enjoy under the old option. Thus, the requirements of paragraph (a)(5) of this section are not met, and this paragraph (a) does not apply to the exchange of the new option for the old option. Therefore, the exchange is a modification of the old options.

Example 6. Spread and ratio tests. E is an employee of S Corporation. E holds an old option that was granted to E by S to purchase 60 shares of S at $12 per share. On June 1, 2005, S Corporation is merged into P Corporation, and on such date P issues a new option to purchase P shares in exchange for E's old option to purchase S

shares. Immediately before the exchange, the fair market value of an S share is $32; immediately after the exchange, the fair market value of a P share is $24. The new option entitles E to buy P shares at $9 per share. Because, on a share-by-share comparison, the ratio of the new option price ($9 per share) to the fair market value of a P share immediately after the exchange ($24 per share) is not more favorable to E than the ratio of the old option price ($12 per share) to the fair market value of an S share immediately before the exchange ($32 per share) (9/24 = 12/32), the requirements of paragraph (a)(5)(iii) of this section are met. The number of shares subject to E's option to purchase P stock is set at 80. Because the excess of the aggregate fair market value over the aggregate option price of the shares subject to E's new option to purchase P stock, $1,200 (80 x $24 minus 80 x $9), is not greater than the excess of the aggregate fair market value over the aggregate option price of the shares subject to E's old option to purchase S stock, $1,200 (60 x $32 minus 60 x $12), the requirements of paragraph (a)(5)(ii) of this section are met.

Example 7. Ratio test and partial substitution. Assume the same facts as in Example 6, except that the fair market value of an S share immediately before the exchange of the new option for the old option is $8, that the option price is $10 per share, and that the fair market value of a P share immediately after the exchange is $12. P sets the new option price at $15 per share. Because, on a share-by-share comparison, the ratio of the new option price ($15 per share) to the fair market value of a P share immediately after the exchange ($12) is not more favorable to E than the ratio of the old option price ($10 per share) to the fair market value of an S share immediately before the substitution ($8 per share) (15/12 = 10/8), the requirements of paragraph (a)(5)(iii) of this section are met. Assume further that the number of shares subject to E's P option is set at 20, as compared to 60 shares under E's old option to buy S stock. Immediately after the exchange, 2 shares of P are worth $24, which is what 3 shares of S were worth immediately before the exchange (2 x $12 = 3 x $8). Thus, to achieve a complete substitution of a new option for E's old option, E would need to receive a new option to purchase 40 shares of P (*i.e.*, 2 shares of P for each 3 shares of S that E could have purchased under the old option (2/3 = 40/60)). Because E's new option is for only 20 shares of P, P has replaced only ½ of E's old option, and the other ½ is still outstanding.

Example 8. Partial substitution. X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and, in a spin-off, distributes the shares of Y Corporation to the stockholders of X Corporation. E, an employee of X Corporation, is thereafter an employee of Y. Y wishes to substitute a new option to purchase some of its stock for E's old option to purchase 100 shares of X. E's old option to purchase shares of X, at $50 a share, was granted when the fair market value of an X share was $50, and an X share was worth $100 just before the distribution of the Y shares to X's stockholders. Immediately after the spin-off, which is also the time of the substitution, each share of X and each share of Y is worth $50. Based on these facts, a new option to purchase 200 shares of Y at an option price of $25 per share could be granted to E in complete substitution of E's old option. It would also be permissible to grant E a new

option to purchase 100 shares of Y, at an option price of $25 per share, in substitution for E's right to purchase 50 of the shares under the old option.

Example 9. Stockholder approval requirements. (i) X Corporation, a publicly traded corporation, adopts an incentive stock option plan that meets the requirements of §1.422-2. Under the plan, options to acquire X stock are granted to X employees. X Corporation is acquired by Y Corporation and becomes a subsidiary corporation of Y Corporation. After the acquisition, X employees remain employees of X. In connection with the acquisition, Y Corporation substitutes new options to acquire Y stock for the old options to acquire X stock previously granted to the employees of X. As a result of this substitution, on exercise of the new options, X employees receive Y Corporation stock.

(ii) Because the requirements of §1.422-2 were met on the date of grant, the substitution of the new Y options for the old X options does not require new stockholder approval. If the other requirements of paragraphs (a)(4) and (5) of this section are met, the issuance of new options for Y stock in exchange for the old options for X stock meets the requirements of this paragraph (a) and is not a modification of the old options.

(iii) Assume the same facts as in paragraphs (i) and (ii) of this Example 9. Assume further that as part of the acquisition, X amends its plan to allow future grants under the plan to be grants to acquire Y stock. Because the amendment of the plan to allow options on a different stock is considered the adoption of a new plan under §1.422-2(b)(2)(iii), the stockholders of X must approve the plan within 12 months before or after the date of the amendment of the plan. If the stockholders of X timely approve the plan, the future grants to acquire Y stock will be incentive stock options (assuming the other requirements of §1.422-2 have been met).

Example 10. Modification. X Corporation merges into Y Corporation. Y Corporation retains employees of X who hold old options to acquire X Corporation stock. When the former employees of X exercise the old options, Y Corporation issues Y stock to the former employees of X. Under paragraph (a)(7) of this section, because Y issues its stock on exercise of the old options for X stock, there is a change in the terms of the old options for X stock. Thus, the issuance of Y stock on exercise of the old options is a modification of the old options.

Example 11. Eligible corporation. (i) D Corporation grants an option to acquire 100 shares of D Corporation stock to E, an employee of D Corporation. S Corporation is a subsidiary of D Corporation. On March 1, 2005, D Corporation spins off S Corporation. E remains an employee of D Corporation. In connection with the spin off, D Corporation substitutes a new option to acquire D Corporation stock and a new option to acquire S Corporation stock for the old option in a manner that meets the requirements of paragraph (a) of this section.

(ii) The substitution of the new option to acquire S and D stock for the old option to acquire D stock is not a modification of the old option. However, because S is no longer a related corporation with respect to D Corporation, E must exercise the option for S stock within three months from March 1, 2005, for the option to be treated as a statutory option. See §1.421-1(h).

(iii) Assume the same facts as in paragraph (i) of this Example 11 except that E's employment with D Corporation is terminated on February 20, 2005. The substitution of the new option to acquire S and D stock for the old option to acquire D stock is not a modification of the old option. However, because the employment relationship between E and D Corporation terminated on February 20, 2005, E must exercise the option for the D and S stock within three months from February 20, 2005, for the option to be treated as a statutory option. See §1.421-1(h).

* * * * *

(c) * * * (1) * * *

(iv) A transfer between spouses or incident to divorce (described in section 1041(a)). The special tax treatment of §1.421-2(a) with respect to the transferred stock applies to the transferee. However, see §1.421-1(b)(2) for the treatment of the transfer of a statutory option incident to divorce.

* * * * *

(3) If an optionee exercises an incentive stock option with statutory option stock and the applicable holding period requirements (under §1.422-1(a) or §1.423-1(a)) with respect to such statutory option stock are not met before such transfer, then sections 354, 355, 356, or 1036 (or so much of 1031 as relates to 1036) do not apply to determine whether there is a disposition of those shares. Therefore, there is a disposition of the statutory option stock, and the special tax treatment of § 1.421-2(a) does not apply to such stock.

(4) * * *

Example 7. On January 1, 2004, X Corporation grants to E, an employee of X Corporation, an incentive stock option to purchase 100 shares of X Corporation stock at $100 per share (the fair market value of an X Corporation share on that date). On January 1, 2005, when the fair market value of a share of X Corporation stock is $200, E exercises half of the option, pays X Corporation $5,000 in cash, and is transferred 50 shares of X Corporation stock with an aggregate fair market value of $10,000. E makes no disposition of the shares before January 2, 2006. Under §1.421-2(a), no income is recognized by E on the transfer of shares pursuant to the exercise of the incentive stock option, and X Corporation is not entitled to any deduction at any time with respect to its transfer of the shares to E. E's basis in the shares is $5,000.

Example 8. Assume the same facts as in Example 7, except that on December 1, 2005, one year and 11 months after the grant of the option and 11 months after the transfer of the 50 shares to E, E uses 25 of those shares, with a fair market value of $5,000, to pay for the remaining 50 shares purchasable under the option. On that day, X Corporation transfers 50 of its shares, with an aggregate fair market value of $10,000, to E. Because E disposed of the 25 shares before the expiration of the applicable holding periods, §1.421-2(a) does not apply to the January 1, 2005, transfer of the 25 shares used by E to exercise the remainder of the option. As a result of the disqualifying disposition of the 25 shares, E recognizes compensation income under the rules of §1.421-2(b).

Example 9. On January 1, 2005, X Corporation grants an incentive stock option to E, an employee of X Corporation. The exercise price of the option is $10 per share. On June 1, 2005, when the fair market value of an X Corporation share is $20, E exercises the option and purchases 5 shares with an aggregate fair market value of $100. On January 1, 2006, when the fair market value of an X Corporation share is $50, X Corporation is acquired by Y Corporation in a section 368(a)(1)(A) reorganization. As part of the acquisition, all X Corporation shares are converted into Y Corporation shares. After the conversion, if an optionee holds a fractional share of Y Corporation stock, Y Corporation will purchase the fractional share for cash equal to its fair market value. After applying the conversion formula to the shares held by E, E has 10 ½ Y Corporation shares. Y Corporation purchases E's one-half share for $25, the fair market value of one-half of a Y Corporation share on the conversion date. Because E sells the one-half share prior to expiration of the holding periods described in §1.422-1(a), the sale is a disqualifying disposition of the one-half share. Thus, in 2006, E must recognize compensation income of $5 (one-half of the fair market value of an X Corporation share on the date of exercise of the option, or $10, less one-half of the exercise price per share, or $5). For purposes of computing any additional gain, E's basis in the one-half share increases to $10 (reflecting the $5 included in income as compensation). E recognizes an additional gain of $15 ($25, the fair market value of the one-half share, less $10, the basis in such share). The extent to which the additional $15 of gain is treated as a redemption of Y Corporation stock is determined under section 302.

(d) Attribution of stock ownership. To determine the amount of stock owned by an individual for purposes of applying the percentage limitations relating to certain stockholders described in §§1.422-2(f) and 1.423-2(d), shares of the employer corporation or of a related corporation that are owned (directly or indirectly) by or for the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, are considered to be owned by the individual. Also, for such purposes, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) shares of the employer corporation or of a related corporation, the shares are considered to be owned proportionately by or for the stockholders, partners, or beneficiaries of the corporation, partnership, estate, or trust. The extent to which stock held by the optionee as a trustee of a voting trust is considered owned by the optionee is determined under all of the facts and circumstances.

(e) Modification, extension, or renewal of option. (1) This paragraph (e) provides rules for determining whether a share of stock transferred to an individual upon the individual's exercise of an option after the terms of the option have been changed is transferred pursuant to the exercise of a statutory option.

(2) Any modification, extension, or renewal of the terms of an option to purchase shares is considered the granting of a new option. The new option may or may not be a statutory option. To determine the date of grant of the new option for purposes of section 422 or 423, see §1.421-1(c).

* * * * *

(4)(i) For purposes of §§1.421-1 through 1.424-1 the term modification means any change in the terms of the option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that gives the optionee additional benefits under the option regardless of whether the optionee in fact benefits from the change in terms. In contrast, for example, a change in the terms of the option shortening the period during which the option is exercisable is not a modification. However, a change providing an extension of the period during which an option may be exercised (such as after termination of employment) or a change providing an alternative to the exercise of the option (such as a stock appreciation right) is a modification regardless of whether the optionee in fact benefits from such extension or alternative right. Similarly, a change providing an additional benefit upon exercise of the option (such as the payment of a cash bonus) or a change providing more favorable terms for payment for the stock purchased under the option (such as the right to tender previously acquired stock) is a modification.

(ii) If an option is not immediately exercisable in full, a change in the terms of the option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of this section. Additionally, no modification occurs if a provision accelerating the time when an option may first be exercised is removed prior to the year in which it would otherwise be triggered. For example, if an acceleration provision is timely removed to avoid exceeding the $100,000 limitation described in §1.422-4, a modification of the option does not occur.

(iii) A change to an option which provides, either by its terms or in substance, that the optionee may receive an additional benefit under the option at the future discretion

of the grantor, is a modification at the time that the option is changed to provide such discretion. In addition, the exercise of discretion to provide an additional benefit is a modification of the option. However, it is not a modification for the grantor to exercise discretion specifically reserved under an option with respect to the payment of a cash bonus at the time of exercise, the availability of a loan at exercise, the right to tender previously acquired stock for the stock purchasable under the option, or the payment of employment taxes and/or required withholding taxes resulting from the exercise of a statutory option. An option is not modified merely because an optionee is offered a change in the terms of an option if the change to the option is not made. An offer to change the terms of an option that remains open less than 30 days is not a modification of the option. However, if an offer to change the terms of an option remains outstanding for 30 days or more, there is a modification of the option as of the date the offer to change the option is made.

(iv) A change in the terms of the stock purchasable under the option that increases the value of the stock is a modification of such option, except to the extent that a new option is substituted for such option by reason of the change in the terms of the stock in accordance with paragraph (a) of this section.

(v) If an option is amended solely to increase the number of shares subject to the option, the increase is not considered a modification of the option but is treated as the grant of a new option for the additional shares. Notwithstanding the previous sentence, if the exercise price and number of shares subject to an option are proportionally adjusted to reflect a stock split (including a reverse stock split) or stock dividend, and the only effect of the stock split or stock dividend is to increase (or

decrease) on a pro rata basis the number of shares owned by each shareholder of the class of stock subject to the option, then the option is not modified if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the option is not less than the aggregate exercise price before the stock split or stock dividend.

(vi) Any change in the terms of an option made in an attempt to qualify the option as a statutory option grants additional benefits to the optionee and is, therefore, a modification. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution in order to meet the requirements of section 422(b)(5) or 423(b)(9) such change is not a modification.

(vii) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(viii) Any inadvertent change to the terms of an option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that is treated as a modification under this paragraph (e) is not considered a modification of the option to the extent the change in the terms of the option is removed by the earlier of the date the option is exercised or the last day of the calendar year during which such change occurred. Thus, for

example, if the terms of an option are inadvertently changed on March 1 to extend the exercise period and the change is removed on November, then if the option is not exercised prior to November 1, the option is not considered modified under this paragraph (e).

* * * * *

(6) [Reserved.]

* * * * *

(f) Definitions. The following definitions apply for purposes of §§1.421-1 through 1.424-1:

(1) Parent corporation. The term parent corporation, or parent, means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(2) Subsidiary corporation. The term subsidiary corporation, or subsidiary, means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in an unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(g) Effective date-- (1) In general. These regulations are effective on August 3, 2004.

(2) Reliance and transition period. For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR-279-81 (49 FR 4504), the 2003 proposed regulations REG-122917-02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004, taxpayers may rely on either the REG-122917-02 or this section. Taxpayers may not rely on LR-279-81 or REG-122917-02 after December 31, 2005. Reliance on LR-279-81, REG-122917-02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

§1.6039-1 and 1.6039-2 [Removed]

Par. 14. Section 1.6039-1 and 1.6039-2 are removed.

Par. 15. A new §1.6039-1 is added to read as follows:

§1.6039-1 Statements to persons with respect to whom information is furnished.

(a) Requirement of statement with respect to incentive stock options under section 6039(a)(1). Every corporation which transfers stock to any person pursuant to such person's exercise of an incentive stock option described in section 422(b) must furnish to such transferee, for each calendar year in which such a transfer occurs, a written statement with respect to the transfer or transfers made during such year. This statement must include the following information--

(1) The name, address, and employer identification number of the corporation transferring the stock;

(2) The name, address, and identifying number of the person to whom the share or shares of stock were transferred;

(3) The name and address of the corporation the stock of which is the subject of the option (if other than the corporation transferring the stock);

(4) The date the option was granted;

(5) The date the shares were transferred to the person exercising the option;

(6) The fair market value of the stock at the time the option was exercised;

(7) The number of shares of stock transferred pursuant to the option;

(8) The type of option under which the transferred shares were acquired; and

(9) The total cost of all the shares.

(b) Requirement of statement with respect to stock purchased under an employee stock purchase plan under section 6039(a)(2). (1) Every corporation which records, or has by its agent recorded, a transfer of the title to stock acquired by the transferor pursuant to the transferor's exercise on or after January 1, 1964, of an option granted under an employee stock purchase plan which meets the requirements of section 423(b), and with respect to which the special rule of section 423(c) applied, must furnish to such transferor, for each calendar year in which such a recorded transfer of title to such stock occurs, a written statement with respect to the transfer or transfers containing the information required by paragraph (b)(2) of this section.

(2) The statement required by paragraph (b)(1) of this section must contain the following information--

(i) The name and address of the corporation whose stock is being transferred;

(ii) The name, address, and identifying number of the transferor;

(iii) The date such stock was transferred to the transferor;

(iv) The number of shares to which title is being transferred; and

(v) The type of option under which the transferred shares were acquired.

(3) If the statement required by this paragraph is made by the authorized transfer agent of the corporation, it is deemed to have been made by the corporation. The term transfer agent, as used in this section, means any designee authorized to keep the stock ownership records of a corporation and to record a transfer of title of the stock of such corporation on behalf of such corporation.

(4) A statement is required by reason of a transfer described in section 6039(a)(2) of a share only with respect to the first transfer of such share by the person who exercised the option. Thus, for example, if the owner has record title to a share or shares of stock transferred to a recognized broker or financial institution and the stock is subsequently sold by such broker or institution (on behalf of the owner), the corporation is only required to furnish a written statement to the owner relating to the transfer of record title to the broker or financial institution. Similarly, a written statement is required when a share of stock is transferred by the optionee to himself and another person (or persons) as joint tenants, tenants by the entirety or tenants in common. However, when stock is originally issued to the optionee and another person (or persons) as joint tenants, or as tenants by the entirety, the written statement required by this paragraph shall be furnished (at such time and in such manner as is provided by this section) with respect to the first transfer of the title to such stock by the optionee.

(5) Every corporation which transfers any share of stock pursuant to the exercise of an option described in this paragraph shall identify such stock in a manner sufficient to enable the accurate reporting of the transfer of record title to such shares. Such identification may be accomplished by assigning to the certificates of stock issued pursuant to the exercise of such options a special serial number or color.

(c) Time for furnishing statements -- (1) In general. Each statement required by this section to be furnished to any person for a calendar year must be furnished to such person on or before January 31 of the year following the year for which the statement is required.

(2) Extension of time. For good cause shown upon written application of the corporation required to furnish statements under this section, the Director, Martinsburg Computing Center, may grant an extension of time not exceeding 30 days in which to furnish such statements. The application must contain a full recital of the reasons for requesting an extension to aid the Director in determining the period of the extension, if any, which will be granted and must be sent to the Martinsburg Computing Center (Attn: Extension of Time Coordinator). Such a request in the form of a letter to the Martinsburg Computing Center, 250 Murall Drive, Kearneysville, West Virginia 25430, signed by the applicant (or its agent) will suffice as an application. The application must be filed on or before the date prescribed in paragraph (c)(1) of this section for furnishing the statements required by this section, and must contain the employer identification number of the corporation required to furnish statements under this section.

(3) Last day for furnishing statement. For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday,

Sunday, or a legal holiday, see §301.7503-1 of this chapter (Regulations on Procedure and Administration).

(d) Statements furnished by mail. For purposes of this section, a statement is considered to be furnished to a person if it is mailed to such person's last known address.

(e) Penalty. For provisions relating to the penalty provided for failure to furnish a statement under this section, see section 6722.

(f) Electronic furnishing of statements. The statements required to be furnished pursuant to this section may be provided in an electronic format in lieu of a paper format, with the consent of the recipient. See §31.6051-1(j) of the Regulations on Employment Taxes and Collection of Income Tax at the Source for further guidance regarding the manner in which such electronic statements must be furnished.

(g) Effective date-- (1) In general. These regulations are effective on August 3, 2004.

(2) Reliance and transition period. For statutory options transferred on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR-279-81 (49 FR 4504), the 2003 proposed regulations REG-122917-02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options transferred after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004, taxpayers may rely on either the REG-122917-02 or this section. Taxpayers may not rely on LR-279-81 or REG-122917-02 after December 31, 2005. Reliance on LR-279-81, REG-

122917-02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

PART 14a--TEMPORARY INCOME TAX REGULATIONS RELATING TO INCENTIVE STOCK OPTIONS

Part 14a [Removed]

Par. 16. Part 14a is removed.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved:

Acting Assistant Secretary of Treasury.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 2, 2004
JS-1820

Treasury Announces Market Financing Estimates

The Treasury Department announced today that it expects net borrowing of marketable debt to total $89 billion in the July – September 2004 quarter. The estimated cash balance on September 30 is $35 billion. In the last quarterly announcement on May 3, 2004, Treasury announced that it expected net borrowing to total $91 billion with an estimated end-of-quarter cash balance of $35 billion. The small change in borrowing is due to higher receipts offset by lower State and Local Government Series net issuances.

Treasury also announced that it expects net borrowing of marketable debt to total $122 billion in the October – December 2004 quarter. The estimated cash balance on December 31 is $35 billion.

During the April – June 2004 quarter, Treasury's net marketable borrowing totaled $31 billion and the cash balance on June 30 was $45 billion. On May 3, Treasury announced that it expected net marketable borrowing to total $38 billion with an estimated end-of-quarter cash balance of $45 billion. The decrease in borrowing is largely attributable to higher receipts and lower outlays offset by lower State and Local Government Series net issuances.

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, August 4.

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REPORTS

- Market Financing Estimates

TREASURY ANNOUNCES MARKET FINANCING ESTIMATES

Today, the Treasury Department announced net borrowing of marketable debt for the July – September 2004 and October - December 2004 quarters.

Quarter	Estimated Borrowing ($ billion)	Estimated End-of-Quarter Cash Balance ($ billion)
Jul-Sep 2004	$89	$35
Oct–Dec 2004	$122	$35

Since 1997, the average absolute forecast error in net market borrowing for the current quarter is $10 billion, of which $1 billion is attributable to differences in the end-of-quarter cash balance. Similarly, the average absolute forecast error for the following quarter is $45 billion, of which $10 billion is attributable to differences in the end-of-quarter cash balance.

The following tables display and reconcile the variation between forecasted and actual net marketable borrowing in the April – June 2004 quarter.

Quarter	Estimated Borrowing ($ billions)	Actual Borrowing ($ billions)	Estimated End-of-Quarter Cash Balance ($ billions)	Actual End-of-Quarter Cash Balance ($ billions)
Apr - Jun 2004	$38	$31	$45	$45

Categories	Chg from May Estimate
Receipts	+$4
Outlays	+4
Non-Marketable Activity	(2)

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, August 4.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 2, 2004
JS-1821

U.S., Iraq, U.K. Jointly Designate Ambassadors
Intel Ops of the Former Hussein Regime
Names Submitted to U.N. 1518 Committee for Member State Freeze

In the fourth tranche of recent actions taken against members of the former Hussein regime, the United States, Iraq and the United Kingdom today jointly designated three individuals and one front company pursuant to Executive Order 13315. The United States has now designated 232 Iraqi-related entities and individuals, comprised of 191 parastatals, 30 individuals and 11 front companies.

"These sham operatives masked themselves as legitimate people and businesses, when they were actually aiding and abetting Saddam's cruel and oppressive regime," said Stuart Levey, the Treasury Department's Under Secretary for Terrorism and Financial Intelligence.

Today's designations by the Treasury Department include a Bangkok-based company serving as a front for the Iraqi Intelligence Service (IIS), along with its owner and director, a former IIS officer suspected of planning attacks in January 2003 against U.S. citizens in Thailand. The designations also include two Iraqi ambassadors who used their senior positions to engage in a variety of illicit activities ranging from the financing of foreign anti-Coalition fighters during Operation Iraqi Freedom to the embezzlement of regime funds.

"It is important for Iraq to identify and sanction those who have used the funds of the Iraqi people illegally to benefit themselves and the Hussein regime," said Rend al-Rahim Francke, Chief of Mission for the Iraq Interests Section.

Today's action is taken pursuant to Executive Order 13315 which blocks property and interests in property of senior officials of the former Iraqi regime within the possession or control of U.S. persons. The United States is also submitting the names of these individuals and associated companies to the U.N. with the recommendation they be listed by the 1518 Committee under U.N. Security Council Resolution (UNSCR) 1483. UNSCR 1483 requires U.N. member states to identify, freeze and transfer to the Development Fund for Iraq (DFI) assets of senior officials of the former Iraqi regime and their immediate family members, including entities owned or controlled by them or by persons acting on their behalf.

OFAC took action today against:

Bloto International Company and Muhannad Juma Y. Al-Tamimi
Information available to the U.S. Government indicates that Bloto International Company (Bloto) was a Bangkok-based trading company that served as a front for the former IIS. The IIS, headed by Tahir Jalil Habbush Al-Tikriti, a senior official of the former regime previously designated under E.O. 13315 and submitted to the U.N. for listing, was the main intelligence agency and internal security division of the former Iraqi regime.

Muhannad Juma Y. Al-Tamimi (Al-Tamimi), the owner and director of Bloto, is suspected of being a former officer of the IIS "Projects Directorate." Information available to the United States indicates that Al-Tamimi was a member of a group operating under the direction of the Iraqi Embassy in Bangkok. In late January 2003, the group attempted to organize a "demonstration" involving kidnappings and attacks targeted at U.S. Embassy employees and U.S. citizens living in Bangkok. Al-Tamimi has also been linked to two IIS officers who came to Bangkok in December 2001 to retrieve explosives being stored in the Iraqi Embassy. Al-Tamimi

was expelled from Thailand in April 2003.

Individual: Muhannad Juma Y. Al-Tamimi
AKA: Muhamad Juma Y. Al-Tamimi
DOB: 1956
POB: Baghdad, Iraq
Iraqi Passport No.: M0817630
Iraqi Passport No.: H0284744

Entity: Bloto International Company
AKA: Bloto International, LTD.
AKA: Bluto International
AKA: Pluto-Dubai Trading Company, LLC
Address: Iraq

Bangkok Offices
Address: 131/13 Soi 7/1 Sukhumvit Road, Wattana, Bangkok, Thailand

Address: 131/13 Sukhumvit Road, Klongtoey Neua sub-district, Wattana District, Bangkok 10110

United Arab Emirates Office
Address: Dubai, United Arab Emirates

Nabil Abdullah Al-Janabi
The U.S. Government has identified Nabil Abdullah Al-Janabi (Al-Janabi) as the former Iraqi Ambassador to Lebanon and as a suspected IIS officer, therefore a senior official of the former Iraqi regime as described in Executive Order 13315 and in United Nations Security Council Resolution 1483. Information available to the U.S. Government indicates that, until the fall of the former regime during Operation Iraqi Freedom, Al-Janabi financed foreign fighters traveling to Iraq to participate in hostilities against Coalition forces, offering $2500 "signing bonuses" to new recruits.

Individual: Nabil Abdullah Al-Janabi
DOB: August 14, 1942
POB: Baghdad, Iraq
Nationality: Iraqi
Passport No.: H101901/1
Address: Beirut, Lebanon

Abbas Khalaf Kunfuth
The U.S. Government has identified Abbas Khalaf Kunfuth (Kunfuth) as the former Iraqi Ambassador to Russia and a senior official of the former Iraqi regime, as described in Executive Order 13315 and in United Nations Security Council Resolution 1483. Information available to the U.S. Government indicates that Kunfuth may have used his senior position to embezzle funds of the former regime.

Individual: Abbas Khalaf Kunfuth
DOB: 1955
POB: Baghdad, Iraq
Nationality: Iraqi
Address: House 21, Lane 17, Subdivision 603,
Dragh District, Al-Mansour, Baghdad

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 2, 2004
js-1822

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. Addresses Wisconsin Teachers and School Administrators at Personal Finance Training Session and Leads Financial Education Roundtable in Madison

Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. today addressed teachers and school administrators, opening the third week of the 2004 Wisconsin Institute of Financial and Economic Education, sponsored by the Wisconsin Jump$tart Coalition for Personal Financial Literacy.

"Our students need to be taught the basics of saving, budgeting and managing credit in order to make informed decisions on how to pay for college, finance a home or start a small business. A solid financial education is vital for our young people if they are to share in America's great opportunities," said Iannicola. "Through your work here and in your classrooms, you're making sure those opportunities are not a privilege of a few, but available to everyone."

The institute's personal finance program trains teachers and administrators on money management and personal finance skills. Program participants can take newly acquired personal finance skills and integrate them into lessons in social studies, economics, math, business and consumer science classes. While in Madison, Iannicola also led the Wisconsin Financial Literacy Roundtable hosted by the Credit Union National Association (CUNA). The roundtable focused on best practices for improving financial literacy.

At the training, Iannicola thanked teachers for their commitment to improving financial education in their schools and shared creative approaches for selecting the best financial education programs. He also provided the participants with suggestions on how they can integrate financial education into existing curricula for maximum impact on student learning and retention. At the roundtable, Iannicola recognized the Wisconsin financial and education communities for their efforts to improve financial literacy in the state.

The Wisconsin Institute of Financial and Economic Education, offers teachers and administrators a choice of three training sessions. The sessions focus on entrepreneurship, saving, investing and insurance, as well as credit and money management. The Wisconsin Jump$tart is an affiliate of the National Jump$tart Coalition for Personal Financial Literacy. Headquartered in Washington, D.C., the National Jump$tart Coalition for Personal Financial Literacy was first convened in 1995 and consists of over 200 organizations focused on improving the financial literacy of America's youth.

Representatives from financial institutions, state government, academic, nonprofit and private sectors also participated in today's CUNA sponsored Wisconsin Financial Literacy Roundtable. The participants included: Philip Heckman, CUNA & Affiliates; David Mancl, Wisconsin Department of Financial Institutions and Wisconsin Jump$tart Coalition for Personal Financial Literacy; Richard Entenmann, Asset Builders of America; Jim Guenther, Economics Wisconsin; Professor Lew Mandell, MoneySKILL, National Jump$tart Coalition and State University of New York at Buffalo; Chris Olson, Wisconsin Credit Union League; Jodi Owens, Wisconsin Department of Workforce Development; Joseph Saari, Precision Information, LLC; Sharon Strom, Wisconsin Department of Public Instruction; Bill Wilcox, CBM Credit Education Foundation, Inc.; Bob Wynn, Financial Education Consultant; Jim Hanson, Center for Personal Finance, CUNA; Mike Miller, Association Services, CUNA; Michelle Cunningham, News Now, CUNA; Ann Peterson, Credit Union Magazine, CUNA; and Kim Kindschi, Wisconsin Bankers

Association. CUNA, a national not-for-profit trade group, is governed by America's credit unions and works with related organizations to provide products and services to credit unions.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning. The Office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: [illegible]

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 2, 2004
JS-1823

Assistant Secretary of the Office of Economic Policy
Mark J. Warshawsky
Statement for the Treasury Borrowing Advisory Committee
of the Bond Market Association

The U.S. economy continued to grow at a solid pace in the months since the last meeting of the Advisory Committee. Real GDP expanded at a 3.0 percent annual rate in the second quarter, following an exceptionally strong performance in the previous four quarters when the economy grew 5.0 percent * the largest such gain in nearly twenty years. We expect improved activity in the second half of the year, based on expanding labor markets, strong investment and export demand, and rising business and consumer confidence.

Personal consumption expenditures (PCE) more than accounted for the slowdown in overall growth in the second quarter. Real PCE rose at a 1.0 percent rate compared to an increase now placed at 4.1 percent in the first quarter. Several factors contributed to the diminished pace, some of which could be considered transitory. A surge in energy prices was one such factor, with the retail price of gasoline climbing 16 percent above the first quarter average. Mortgage refinancings have helped support growth in consumption expenditures in the past few years through lower payments and cash-out features. However, refinancings shrank 40 percent in the second quarter as mortgage interest rates moved higher.

The fundamentals of the household sector nonetheless remain strong. Aggregate wage growth has been revitalized by improving labor markets. As a result, real disposable personal income has risen at approximately a 3 percent annual rate in each of the past two quarters. It might also be noted that state and local income taxes paid by individuals have been steady as a share of personal income, rather than rising as had been widely expected. Household wealth continues to rise due to higher home values, with net worth hitting a record $45.2 trillion in the first quarter. Consumer balance sheets are in good shape, with interest rates still historically low, monthly financial obligations and debt service payments in relation to disposable personal income diminishing, and delinquency and loan charge-off rates on consumer borrowing moving down.

Activity in the business sector of the economy in the second quarter remained quite strong. Powered by a 10 percent gain in equipment and software and a 5.2 percent increase in investment in structures, business fixed investment increased at an 8.9 percent annual rate * double the pace of the first quarter. Inventory investment also added to growth in the second quarter, contributing 0.3 percentage point. The healthy pickup in business demand for goods, as a well as a 14.6 percent surge in goods exports in the second quarter, contributed to a 7.1 percent annual rate increase in manufacturing production in the quarter, the largest gain since 1999. Exports have been rising at a rapid pace in the past four quarters, reflecting the fact that the desired improvement in economic activity abroad is finally underway. In the second quarter, exports grew at a faster rate than imports. As a result, the trade deficit shaved just 0.1 percentage point off real GDP growth after having reduced growth by 0.8 point in the first quarter.

Strong profits growth, low risk spreads, and renewed business optimism about the strength and sustainability of aggregate demand have been the key drivers of the ongoing rise in business investment, supported as well by tax incentives. Corporate profits as measured in the GDP accounts (which states inventories and depreciation on a replacement-cost basis) were nearly 28 percent higher in the first quarter than a year earlier, pushing the profit margin (in relation to gross domestic income) up to 10.2 percent - the highest since 1997. Surveys of business

confidence and capital spending intentions have been very favorable and inventories are lean, suggesting business investment is poised for further growth.

Higher profits and cash flow have also allowed businesses to increase hiring. Monthly job growth accelerated sharply at the end of the first quarter and remained at high levels through the first two months of the second quarter, averaging 304,000 per month from March to May before slowing to a still-solid 112,000 increase in June. The economy has now added 1.5 million new payroll jobs since last August. This growth in large measure reflects the response to the Jobs and Growth tax relief act which went into effect in the second quarter of 2003.

The outlook for the economy in the remainder of the year is quite favorable as the factors holding growth down in the second quarter dissipate. Energy prices are expected to stabilize, removing much of the upward pressure on inflation. In addition, more generous motor vehicle incentives may boost consumer auto purchases after a poor performance in the second quarter. Labor market indicators point to continued job growth, providing a lift to aggregate wages. Both the Conference Board and University of Michigan measures of consumer confidence suggest an increasingly optimistic attitude on the part of consumers.

Overall, the economy is generally expected to expand at more than a 4 percent annual rate in the third and fourth quarters. Recent statistical readings, some of them forward-looking, provide additional perspective on current conditions and the near-term outlook, and most seem to point to an improving economy. A few examples include:

- Leading indicators, which were 3.4 percent higher in the second quarter than the first, continuing to reflect economic strength.
- Unfilled orders for durable goods, which have soared by 8 percent over the past year, pointing to ongoing need for factory production.
- Permits for new home construction remain above new home starts, suggesting sustained strength in residential investment in the near-term - a view confirmed by a high level of home builder optimism.
- Continuing claims for unemployment insurance are extending their downtrend. In the past two weeks, the four-week moving average has been the lowest in three years, suggesting a strengthening labor market.
- Manpower's Employment Outlook Survey measure of net hiring strength in the third quarter remained at the highest level since the first quarter of 2001.
- The latest quarterly industry survey of the National Association of Business Economics found that the share of respondents reporting that demand was rising was 52 percent on net -- the highest in four years.
- Regional measures of industrial activity confirm ongoing strength and good prospects for growth in capital investment. The Business Outlook Survey of the Philadelphia Federal Reserve Bank reported that the index measuring the 6-month outlook for capital expenditures jumped to 28 in July from 18.6 in June.
- Finally, the Institute for Supply Management's manufacturing index rose to 62 in July. The index has now been above 60 for nine consecutive months, the longest period of such strength in more than thirty years. (Readings above 50 are generally consistent with expanding activity in the manufacturing sector.)

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 4, 2004
JS-1824

Minutes Of The Meeting Of The Treasury Borrowing Advisory Committee Of The Bond Market Association August 3, 2004

The Committee convened in closed session at the Hay-Adams Hotel at 11:45 a.m. One member of the Committee, Keith Anderson, was not present. Acting Assistant Secretary for Financial Markets Timothy Bitsberger welcomed the Committee and gave them the charge.

The Committee first addressed the question in the Committee charge (attached) on reducing marketable issuance in the face of declining financing needs and the impact of such reductions on market liquidity.

As a preface to the Committee discussion, Mr. Bitsberger presented a series of charts (attached) showing Treasury's projected debt and issuance distribution, financing residuals, rollover, and hypothetical announced auction sizes. Two key assumptions used in the charts were the latest OMB mid-session review budget numbers and an assumption of stable bill issuance. Mr. Bitsberger explained that there is no formal target for bills as a percentage of total issuance outstanding debt, but Treasury has an interest in maintaining the robustness of the bill market because it provides great flexibility and low cost financing. The charts indicated that if lower deficits are realized, and bill issuance is maintained at current levels, that coupon issuance level will have to be reduced modestly. The charts indicated that the distribution of issuance, the distribution of outstandings, rollover amounts, as well as hypothetical auction sizes remain within historical norms.

The Committee discussed what, if any, changes were needed to the calendar or issue sizes and the liquidity effects of such changes. The Committee generally agreed that Treasury's current calendar has a great deal of flexibility and that the right tools were in place to respond to changes in financing needs. No changes to the calendar are needed at this time and lower borrowing requirements could be met with reduced issue sizes in coupons across the nominal curve. Members also felt that if deficits continued to decline changes to the calendar could be contemplated, such as eliminating the 10-year reopening. Some members pointed out that the 10-year reopening added flexibility and smoothed borrowing patterns. Others pointed out that old off-the-run 20- and 30-year issues were starting to roll down into the 10-year sector and should offer more liquidity should the Treasury decide at some future point to cut back on 10-year issuance. Another member said that Treasury's primary goal was to borrow at lowest cost and that it should not let liquidity concerns divert Treasury from this goal; the markets have adapted in the past and will adapt in the future to changes. Transparency was recognized to be important in facilitating market adaptations.

Members generally felt that that the size of issues, particularly in the 10-year note, which has in the past traded tight in financing markets and sometimes with a significant level of fails to deliver, was not the general cause of liquidity problems. They noted that the market has traded much smaller sizes in the past without liquidity problems. One member noted that the frequency of trading in other products that require the use of 10-year notes as hedges has put strain on the lending markets and has caused many of the liquidity problems. The situation is often compounded by the trading practices of some sizable foreign purchasers of Treasuries, who do not participate in the repo market because they are constrained by their own internal regulations or customs. It was suggested that Treasury could go with smaller sizes if the market's repo concerns were addressed either via a repo facility established by Treasury or a change in security lending behavior by large foreign holders. Members also noted that the past fails in the 10-year notes were exacerbated by the rate environment, and an historically rapid rise in rates.

The Committee next addressed the question in the charge dealing with the distribution of projected levels of interest rates, inflation and deficits and a range of probable outcomes. Mr. Bitsberger presented a series of charts (attached) depicting the distribution of outcomes for each of these components. This was a continuation of sensitivity analysis presented in prior meetings where Treasury presented charts showing the budget uncertainty associated with economic forecasts, legislation, and technical modeling factors. The Committee was asked whether there was anything presented within the charts that raised concerns for debt management and whether there were other factors that Treasury should consider.

The Committee generally felt that the outcomes presented in the analysis were "too stable" and did not incorporate sufficient risk; bigger shocks or stresses needed to be applied to the models or some sort of risk premium needed to be included in the models. They also suggested that the static modeling used in the analysis was too simplistic; they suggested incorporating dynamic modeling techniques such as reaction functions: for example, incorporating a function that considers the impact of changes in inflation on the level of interest rates. The Committee also suggested that attempting to disaggregate inflation and interest rate components might result in some double counting effects.

One committee member felt that the modeling beyond five years was not very valuable because the uncertainty was too great. Another stated that projections beyond two years were unlikely to provide much guidance about actual outcomes. A third stated that longer-term modeling needed to be considered, even if its forecasting value was limited. It still might indicate some general trend that needs to be considered despite the uncertainty. At the close of the discussion on this issue, the Committee, upon Mr. Bitsberger's request, agreed to work with Treasury and suggest ways to improve the analysis in the future.

The Committee then discussed the third question in the charge dealing with the risks of foreign ownership of Treasury securities. Mr. Bitsberger presented a single chart showing the increase in foreign ownership of Treasury securities as a percentage of privately-held outstanding.

The Committee overwhelmingly felt that broad foreign ownership of Treasury securities was beneficial, in that it lowered domestic interest rates. They stated that in their experience foreign accounts were "buy-and-hold" investors and were much less apt to sell or lend securities in the repo market. They stated that the idea that foreign investors would rapidly "dump" bonds is not consistent with historical experience and illogical, since it would be detrimental to foreign holders' markets.

One member contended that foreign investors generally buy Treasury securities to support their foreign exchange policies and that a change in such policies from a foreign holder with a large position could be detrimental to the Treasury market. Another countered that the trend in foreign holdings was long-term and upward and that any change in foreign exchange policies would have a transient effect on the market at most. Other members noted that foreign investment in euro-denominated debt was also growing and that growth in holdings of both euro-and dollar-denominated debt was related to globalization and increases in wealth in foreign countries. These investors want the safety and stability of dollar- and euro-denominated debt. One Committee member suggested Treasury try to estimate the elasticity the demand for Treasuries, to determine what the effects of a substantial falloff in foreign participation would be on the market.

Another member raised issues about the transparency of foreign purchases of Treasury securities at Treasury auctions, arguing that some foreign participants are not subject to the same reporting requirements as domestic participants. The disparate reporting requirements makes it hard for dealers to estimate the level of foreign account participation in auctions, which in turn affects dealers' estimates of the floating supply ahead of an auction - which ultimately has price impacts at auction in the form of an uncertainty premium. This lack of transparency, it was argued, could have a negative impact on an auction if a foreign entity that has been participating heavily in auctions, unexpectedly changes its participation level because it has adopted a change in its foreign exchange policy. Members felt that greater transparency in this matter would be beneficial.

The discussion briefly turned to the Committee's final borrowing recommendations for the August refunding and the remaining financing for this quarter as well as the October-December quarter. Those charts are attached.

The meeting adjourned at 1:05 p.m.

The Committee reconvened at the Hay-Adams Hotel at 5:35 p.m. One member of the Committee, Keith Anderson, was not present. The Chairman presented the Committee report to the Under Secretary for Domestic Finance, Brian Roseboro and Acting Assistant Secretary for Financial Markets, Tim Bitsberger, and Deputy Assistant Secretary for Government Financial Policy, Roger Kodat. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 5:50 p.m.

Jeff Huther

Director

Office of Debt Management

August 3, 2004

Certified by:

Mark B. Werner, Chairman

Treasury Borrowing Advisory Committee

of The Bond Market Association

August 3, 2004

Treasury Borrowing Advisory Committee Quarterly Meeting Committee Charge – August 3, 2004

Liquidity and Reduced Financing Needs

We would like the Committee's view on reducing marketable issuance in the face of declining financing needs and the impact of such reductions on market liquidity.

Distribution of Inflation, Interest Rate, and Deficit

We will present charts to the Committee showing projected levels of interest rates, inflation and deficits and a range of probable outcomes. Does the Committee have a views on whether these are the correct variables to focus on? Is there anything presented within these charts that raises concerns? Are there any related indicators that Treasury should consider?

Foreign Ownership of Treasury Securities

Treasury is frequently asked about levels of foreign ownership. We believe that broad foreign ownership lowers Treasury borrowing costs and represents a vote of confidence by global investors. Does the Committee have any views they would like to share with us on this issue.

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately $28.8 billion of privately held notes and bonds maturing or called on August 15.
- The composition of Treasury marketable financing for the remainder of the July – September quarter, including cash management bills.

- The composition of Treasury marketable financing for the October – December quarter.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 4, 2004
JS-1825

Acting Assistant Secretary for Financial Markets Timothy S. Bitsberger
August 2004 Quarterly Refunding Statement

Treasury will maintain its 10-year note reopening policy. We are offering $51.0 billion of notes to refund approximately $28.8 billion of privately held securities and Government account holdings maturing on August 15, raising approximately $22.2 billion. The securities are:

- A new 3-year note in the amount of $22 billion, maturing August 15, 2007; - A new 5-year note in the amount of $15 billion, maturing August 15, 2009; - A new 10-year note in the amount of $14 billion, maturing August 15, 2014.

These securities will be auctioned on a yield basis at 1:00 PM Eastern time on Monday, August 9, Wednesday, August 11, and Thursday, August 12, respectively. All of these auctions will settle on Monday, August 16. The balance of our financing requirements will be met with weekly bills, monthly 2-year and 5-year notes, the September 10-year note reopening, and the October 10-year and 5-year TIPS. Treasury is also likely to issue cash management bills in early September and early October.

Treasury Issuance Calendar

We have examined the continuing need for large liquid issuance of our securities and believe that this need can best be met, given our projected borrowing requirements, with our existing issuance patterns. The current calendar meets our projected borrowing needs flexibly and in a manner that is consistent with low cost financing over time. If our financing needs decline in line with our central projections, we expect small reductions in the sizes of our coupon offerings. When more substantial changes in our issuance calendar are needed, we will announce those changes one quarter before implementation.

State and Local Government Securities (SLGS) Proposed Regulatory Changes

By September 30, 2004 Treasury will announce proposed regulatory changes for dealing with certain trading activities that we view are against the spirit and purpose of the SLGS program and are detrimental to efficient Treasury financing. There will be a 30-day comment period following publication of the proposed rule. Treasury will consider comments from market participants regarding the proposed rule before publishing a final rule.

Treasury Systems Changes

· Six-Decimal Price Awards in Treasury Auctions: Beginning September 20, Treasury will compute price awards in auctions to six decimal places per hundred. For information on computations, please see our website at http://www.publicdebt.treas.gov/of/ofcalc6decimal.htm. Institutions are encouraged to use the formulas for internal testing to determine whether or not changes to their back-office systems will be necessary. Any questions regarding this testing should be directed to the Bureau of the Public Debt, Office of Financing at (202) 504-3550.

· Changing Limits on Non-competitive Bill Awards: Beginning September 20, the limit on non-competitive awards will be $5 million for all auctions.

· Changes Regarding Zero Fill on Decimals: If an investor submits a bid with an

insufficient number of decimal places, Treasury's auction interface, TAAPSLink, will now automatically fill the remaining decimals with zeros (e.g. if a bid is submitted incorrectly at 3.2%, the bid will automatically be changed to 3.200%). This change will take effect on September 20.

The next quarterly refunding announcement will take place on Wednesday, November 3, 2004. Please send comments and suggestions on these subjects or others relating to debt management to debt.management@do.treas.gov.

-30-

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 4, 2004
JS-1826

Report To The Secretary Of The Treasury From The Treasury Borrowing Advisory Committee Of The Bond Market Association August 3, 2004

The economy has slowed since the Committee's last meeting in May, as the surge in energy prices since last winter has cut into household purchasing power and restrained consumer spending. The advance report on 2Q real GDP shows growth slowing to a 3.0% pace from a 4.5% growth pace in 1Q. Real consumer spending slowed to a 1.0% pace while other private-sector spending – business fixed investment, housing, and exports – each accelerated in 2Q. It appears that growth is rebounding this quarter despite the further increase in the price of oil. Supply-side manufacturing and housing surveys in hand for July are at elevated levels consistent with vibrant economic expansion. And demand-side indicators of household demand for July (including a better tone to the reports from retailers and automakers and improved consumer confidence readings) point to stronger growth of consumer spending.

Core inflation as measured by the core PCE price index has accelerated from 1.2% in 2003 (q4/q4) to 2.1% at an annual rate in 2004 1Q and a 1.8% rate in 2Q. The near-term outlook for core inflation is mixed. The slowdown in consumer spending and outlook for increased discounting, points to some moderation, while the latest business surveys generally point to more extensive price increases.

The Treasury market was mixed over the past three months – rates initially continued to rise as market participants digested strong economic data, but then rallied back after data weakened somewhat. Over the last three months, 2-year yields have risen 33bp while 10-year yields have fallen 10bp, and the yield curve has flattened 48bp. Currently, the market is fully pricing in a 25bp tightening at the August 10 th FOMC meeting and cumulatively 80bp of tightening by year-end.

With about 80% of the S&P 500 firms having reported, second-quarter earnings are meeting expectations of $16.68 per share. This figure is 24.6% higher than year ago earnings per share. However, with the economic expansion now incorporating meaningful job growth, labor expense has accelerated and profit growth appears to be slowing. Broad measures of stock market performance were flat during 2Q but have declined nearly 5% so far in 3Q, with losses especially pronounced for tech stocks. Recent losses seem to reflect concerns about the effects that higher oil prices will have on an economy that is already slowing, but some may also reflect political uncertainties related to the November election.

The real trade-weighted dollar has appreciated 2.6% since the end of the first quarter. Currency appreciation seems to reflect the prospect for significant Fed tightening over the next year. The dollar has appreciated against both the yen and the euro.

Federal budget performance over the last few months was stronger than expected, mainly reflecting upside surprises on income growth and associated tax revenues. Consequently, over the past three months, many analysts have lowered forecasts of the budget deficit by roughly $50 billion for both this year and next year, which is generally consistent with official estimates as well.

Against this economic and financial backdrop, the members of the Committee began consideration of debt management questions in the Quarterly Charge. Following their standard format, Treasury presented a chart package for discussion

that will be released as part of the Treasury refunding announcement.

The first part of the Charge asked the Committee for its view on reducing marketable issuance in the face of a declining financing need and the impact of such reduction on market liquidity. In their presentation, Treasury made several points. They felt issuance could easily be raised, but a reduction in issuance would be more difficult for the markets. One of the factors for them to be mindful of is current liquidity conditions in the markets. Additionally, Treasury was clear that they relied heavily on the bill market to handle much of their financing need. Maintaining a robust bill market is critical to Treasury's daily market operations. In order to retain the flexibility that bills afford them, Treasury asked Committee members if they were to keep bill issuance static, could they reduce coupon issuance in an environment where they are managing to a favorable deficit forecast.

Several Committee members suggested that Treasury needs to be concerned with this issue, and emphasized the need for a liquid coupon curve and repo market. There was more interest in maintaining current issuance levels in the 5-year and 10-year maturities versus the 2-year and 3-year maturity sectors of the coupon curve. The longer sectors were considered to be more critical to the market at this juncture, whether used as investment vehicles or as hedging vehicles. There was discussion of the 10-year maturity sector as to whether there was a need to consider the elimination of the 10-year note reopening. The Committee felt that this was not necessary at this point in time. Some members of the Committee felt there could be problems associated with reducing issuance in certain sectors if market participants were not certain of their ability to borrow issues freely. The Committee suggested that Treasury should work to insure that foreign holders lend securities more readily. Treasury was encouraged to add more transparency to the types of buyers of securities and to develop a repo facility to balance market-driven shortages in securities. One member expressed concern with the shortening of the average maturity of the debt. Consensus from the Committee was that the raised issuance in 5-year, 10-year and TIPS securities has compensated for this over the past year. The Committee concluded the first part of the Charge by suggesting that Treasury can reduce issuance along the coupon curve provided they work with market participants to maintain a transparent and robust repo market.

The Committee then took up the second part of the Charge. In it, Treasury asked the Committee to discuss slides that could help illustrate a variety of risks to forecast, given different outcomes for inflation, interest rates and fiscal balances. Treasury presented a slide which introduced scenarios for budget deficits and surpluses in coming years based on forecast deviations experienced over the past 15 years. Similarly, Treasury presented charts showing various interest rate levels and inflation rates. Treasury then developed the risk scenarios by illustrating the impact of modeled outcomes on interest expense nominally and in relation to outlays. Treasury noted that their presentation of the slides was meant to be an initial effort to prompt discussions and that the slides are overly simplified by design.

Committee members noted the over simplified nature of the scenarios, but felt in general that the effort to discuss the scenarios was an important step for Treasury to take. Members differed as to whether Treasury should include scenarios based upon inflation forecasts. Some stated they were implicitly captured in interest rate scenarios. Others felt that inflation should be included as an important single variable to consider when assessing risks. Some members felt that limiting scenarios to short time frames, two or three years, would make them more illustrative than longer scenarios where complex interplay of the variables can lead to faulted conclusions. In general, most members felt that Treasury had isolated the correct variables to include in future risk scenario analyses. The Committee agreed to work with Treasury on an ongoing basis, further developing models which are accurate representations of potential risk outcomes.

In the third part of the Charge, Treasury asked for the Committee to share its views on the growing participation of foreign investors in the U.S. Treasury market. Treasury stated its belief that foreign participation lowers borrowing costs and reflects confidence of external lenders in the United States. Treasury presented a slide showing increasing percentages of Treasuries held abroad in relation to total privately held public debt.

The Committee noted the strength of the trend illustrated in the slide. Most felt that though the trend may well moderate, it was unlikely to reverse soon. The members

stated that foreign participants in the U.S. Treasury market were likely to continue to invest a large portion of their current account surpluses in assets of superior credit quality and liquidity. Some members stated that as foreign participants become increasingly large holders of U.S. Treasuries, it will be important to ensure their participation in repo markets. These members expressed concerns that the markets could potentially be disrupted without this important change in foreign investor participation. Members strongly encouraged Treasury to actively further this discussion with participants in Asia, where accumulation of official reserves has been rapid in recent years. Members also noted the beneficial impact of low sovereign interest rates on other financial assets. In general, members felt that Treasury did not face a meaningful intermediate term risk to steady foreign investments in Treasuries, though most felt it was likely that the current, very rapid pace of U.S. Treasury securities accumulation would abate later in the year.

The Committee then addressed the question of the composition of Treasury notes to refund approximately $28.8 billion of privately held notes and bonds maturing or called on August 15, 2004, as well as the composition of Treasury marketable financing for the remainder of the July-September quarter, including cash management bills and the October-December quarter, including cash management bills. To refund $28.8 billion of privately held notes and bonds maturing August 15, 2004, the Committee recommended a $24 billion 3-year note due 8/15/07, a $15 billion 5-year note due 8/15/09, and a $15 billion 10-year note due 8/15/14. For the remainder of the quarter, the Committee recommended a $24 billion 2-year note issued in August and a $24 billion 2-year note issued in September, a $15 billion 5-year note issued in September and a $10 billion reopening of the 10-year note in September. The Committee also recommended a $25 billion 12-day cash management bill issued 9/3/04 and maturing 9/15/04. For the October-December quarter, the Committee recommended financing as contained in the attached table. Relevant features include three $24 billion monthly 2-year notes, a $24 billion 3-year note, one $15 billion and 2 $14 billion monthly 5-year notes, a $13 billion 10-year note in November followed by a $8 billion reopening of that 10-year note in December. The Committee further recommended a $14 billion 5-year TIPS for issuance in October as well as a $9 billion reopening of the 7/15/14 10-year TIPS in October.

Respectfully submitted,

Mark B. Werner
Chairman

Ian Banwell
Vice Chairman

Attachments (2)

REPORTS

- Q3 Tables
- Q4 Tables

US TREASURY FINANCING SCHEDULE FOR 3rd QUARTER 2004
BILLIONS OF DOLLARS

ISSUE	ANNOUNCEMENT DATE	AUCTION DATE	SETTLEMENT DATE	OFFERED AMOUNT 4-WK	OFFERED AMOUNT 3-MO	OFFERED AMOUNT 6-MO	MATURING AMOUNT	NEW MONEY
4-WEEK AND 3&6 MONTH BILLS	6/24	6/28	7/1	9.00 A	17.00 A	15.00 A	56.64	-15.64
	7/1	7/6	7/8	18.00 A	18.00 A	16.00 A	56.34	-4.34
	7/8	7/12	7/15	22.00 A	18.00 A	16.00 A	46.39	9.61
	7/15	7/19	7/22	22.00 A	18.00 A	16.00 A	41.00	15.00
	7/22	7/26	7/29	19.00 A	18.00 A	16.00 A	41.96	11.05
	7/29	8/2	8/5	19.00 A	18.00 A	16.00 A	52.66	0.34
	8/5	8/9	8/12	15.00	18.00	17.00	57.00	-7.00
	8/12	8/16	8/19	18.00	18.00	17.00	57.00	-4.00
	8/19	8/23	8/26	21.00	18.00	17.00	54.00	2.00
	8/26	8/30	9/2	17.00	18.00	17.00	54.00	-2.00
	9/2	9/7	9/9	18.00	18.00	17.00	50.00	3.00
	9/9	9/13	9/16	17.00	18.00	17.00	51.00	1.00
	9/16	9/20	9/23	17.00	18.00	17.00	54.00	-2.00
	9/23	9/27	9/30	18.00	18.00	17.00	49.00	4.00
					732.00		720.99	11.01
CASH MANAGEMENT BILLS								
13-Day bill	6/29 Matures 7/15	7/1	7/2		21.00 A		21.00	0.00
7-Day bill	7/2 Matures 7/15	7/6	7/8		6.00 A		6.00	0.00
12-Day bill	9/1 Matures 9/15	9/2	9/3		25.00		25.00	0.00
COUPONS						CHANGE IN SIZE		
5-Year Note	7/1	7/7	7/15		15.00 A			15.00
10-Year TIPS	7/1	7/8	7/15		10.00 A	-2.00		10.00
20-Year TIPS	7/22	7/27	7/30		11.00 A	11.00		11.00
2-Year Note	7/26	7/28	8/2		24.00 A	-1.00	26.24	-2.24
3-Year Note	8/4	8/9	8/16		24.00			24.00
5-Year Note	8/4	8/11	8/16		15.00		15.35	-0.35
10-Year Note	8/4	8/12	8/16		15.00		13.41	1.59
2-Year Note	8/23	8/25	8/31		24.00		26.74	-2.74
5-Year Note	9/2	9/8	9/15		15.00			15.00
10-Year Note (R)	9/2	9/9	9/15		10.00			10.00
2-Year Note	9/27	9/29	9/30		24.00		27.00	-3.00
					187.00		108.75	**78.26**

R = Reopening
A = Announced

Treasury announced a Q3 borrowing need of $89 billion on Aug 2nd

NET CASH RAISED THIS QUARTER: 89.27

US TREASURY FINANCING SCHEDULE FOR 4th QUARTER 2004
BILLIONS OF DOLLARS

ISSUE	ANNOUNCEMENT DATE	AUCTION DATE	SETTLEMENT DATE	OFFERED AMOUNT 4-WK	OFFERED AMOUNT 3-MO	OFFERED AMOUNT 6-MO	MATURING AMOUNT	NEW MONEY
4-WEEK AND 3&6 MONTH BILLS	9/30	10/4	10/7	17.00	19.00	19.00	50.00	5.00
	10/7	10/12	10/14	17.00	19.00	19.00	48.00	7.00
	10/14	10/18	10/21	19.00	19.00	19.00	48.00	9.00
	10/21	10/25	10/28	21.00	19.00	19.00	50.00	9.00
	10/28	11/1	11/4	18.00	19.00	19.00	50.00	6.00
	11/4	11/8	11/12	15.00	19.00	19.00	50.00	3.00
	11/12	11/15	11/18	19.00	19.00	19.00	52.00	5.00
	11/18	11/22	11/26	21.00	19.00	19.00	54.00	5.00
	11/26	11/29	12/2	19.00	19.00	19.00	51.00	6.00
	12/2	12/6	12/9	19.00	19.00	18.00	48.00	8.00
	12/9	12/13	12/16	17.00	19.00	18.00	52.00	2.00
	12/16	12/20	12/23	19.00	19.00	17.00	54.00	1.00
	12/23	12/27	12/30	17.00	19.00	17.00	52.00	1.00
					726.00		659.00	67.00
CASH MANAGEMENT BILLS								
10-Day Bill	10/1	10/4	10/5		20.00		20.00	0.00
	Matures 10/15							
12-Day Bill	12/1	12/2	12/3		25.00		25.00	0.00
	Matures 12/15							
COUPONS						CHANGE IN SIZE		
5-Year Note	10/4	10/6	10/15		15.00			15.00
10-Year TIPS (R)	10/4	10/7	10/15		9.00			9.00
5-Year TIPS	10/21	10/26	10/29		14.00	14.00		14.00
2-Year Note	10/25	10/27	11/1		24.00		26.88	-2.88
3-Year Note	11/3	11/8	11/15		24.00			24.00
5-Year Note	11/3	11/9	11/15		14.00	-1.00	27.77	-13.77
10-Year Note	11/3	11/12	11/15		13.00	-2.00	20.24	-7.24
2-Year Note	11/22	11/24	11/30		24.00		26.99	-2.99
5-Year Note	12/6	12/8	12/15		14.00			14.00
10-Year Note (R)	12/6	12/9	12/15		8.00	-2.00		8.00
2-Year Note	12/27	12/29	12/31		24.00		26.22	-2.22
					183.00		128.10	**54.90**

R = Reopening
A = Announced

Treasury announced a Q4 borrowing need of $122 billion on Aug 2nd

NET CASH RAISED THIS QUARTER: 121.90

FROM THE OFFICE OF PUBLIC AFFAIRS

August 4, 2004
2004-8-4-12-29-22-11183

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 $82,039 million as of the end of that week, compared to $82,585 million as of the end of the prior week.

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

	July 23, 2004			July 30, 2004		
TOTAL		82,585			82,039	
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	10,803	14,285	25,088	10,795	14,121	24,916
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	10,835	2,871	13,706	10,694	2,838	13,532
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]			20,083			19,961
3. Special Drawing Rights (SDRs) [2]			12,663			12,586
4. Gold Stock [3]			11,045			11,045
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	July 23, 2004			July 30, 2004		
	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

	July 23, 2004			July 30, 2004		
	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 IMF data for the prior month end.

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 3, 2004
JS-1830

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. Teaches Personal Finance Skills to Students at the Minnesota Correctional Facility at Red Wing

Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. today taught a personal finance lesson to a class of 35 students at the Minnesota Correctional Facility at Red Wing. The correctional facility is a state facility designed to provide program services for serious and chronic male juvenile offenders. The facility provides assessment, treatment, education and community transition services designed to equip residents with the skills, knowledge and abilities to become successful members of their communities.

During the lesson, Iannicola encouraged the students to take advantage of learning and developing good personal finance management skills. He also explained how doing so can help them succeed in establishing credit, creating financial security and saving money toward the purchase of a car, a home or obtaining a college degree. Iannicola also thanked the program director at the facility for recognizing the importance of improving the financial education skills of its students.

"Through the Experiential Life Skills Program, Director John Handy and the dedicated staff of the Minnesota Correctional Facility at Red Wing are doing a commendable job of reaching out to the residents here to give them essential life skills," said Iannicola. "John wisely recognized that financial literacy is one of those essential life skills and that's why I'm here. It is also inspiring to see the efforts of the residents as each tries to take advantage of this training to turn a troubled past into a promising future, and to turn a second chance into a better life," Iannicola continued.

The facility's program assists residents as they return to the community. Residents who achieve a GED or high school diploma may be assigned to the Experiential Life Skills Program. Activities focus on money management, independent living and employment retention skills. The program includes a work activity component, which allows residents to apply employment retention skills in work settings at the facility. Staff also coordinates transitional services for residents returning to community.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning. The Office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 3, 2004
JS-1831

Treasury And IRS Issue Depreciation Regulations

Today the Treasury Department and Internal Revenue Service issued guidance relating to the election to deduct the cost of certain tangible property and computer software. The regulations reflect changes to the law made by the Jobs and Growth Tax Relief Reconciliation Act of 2003.

The proposed and temporary regulations issued today generally permit small business taxpayers to elect to deduct up to $100,000 of the cost of qualifying property purchased and placed in service in a taxable year beginning after 2002 and before 2006. Additionally, taxpayers are permitted to make or revoke an election on an amended return for those taxable years without the consent of the Commissioner.

"The ability to expense up to $100,000 of the cost of depreciable property will significantly reduce the record-keeping burden imposed on small business taxpayers," stated Acting Treasury Assistant Secretary for Tax Policy Greg Jenner. "In addition, the regulations greatly simplify the manner in which taxpayers may make or revoke these elections and provide flexibility to small business taxpayers to ensure the election is to their advantage."

The temporary regulations are effective for taxable years beginning after 2002 and before 2006.

The text of the proposed and temporary regulations is attached.

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REPORTS

- REG 152549-03
- TD 9146

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-152549-03]

RIN 1545-BC69

Section 179 Elections

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: 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 section 179 of the Internal Revenue Code relating to the election to expense the cost of property subject to section 179. The temporary regulations reflect changes to the law made by the Jobs and Growth Tax Relief Reconciliation Act of 2003. 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 November 2, 2004. Requests to speak with outlines of topics to be discussed at the public hearing scheduled for Tuesday, November 30, 2004, at 10 a.m., must be received by November 9, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-152549-03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC, 20044.

Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-152549-03), Courier=s Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent electronically, via the IRS Internet site at: www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS - REG-152549-03). The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Winston Douglas, (202) 622-3110; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Robin Jones, (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(d)). 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 October 4, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper

performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (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 service to provide information.

The collections of information in this proposed regulation are in §§1.179-2T and 1.179-5T. This information is required by §1.179-2T to insure that married individuals filing separate returns properly allocate the cost of section 179 property elected to be expensed in a taxable year and that the dollar limitation is properly allocated among the component members of a controlled group. Also, this information is required by §1.179-5T to insure the specific identification of each piece of acquired section 179 property and reflect how and from whom such property was placed in service. This information will be used for audit and examination purposes. The collection of information is required to obtain a benefit. The likely respondents and/or recordkeepers are individuals, farms, and small businesses.

Estimated total annual reporting and/or recordkeeping burden: 3,015,000 hours.

The estimated annual burden per respondent/recordkeeper varies from .50 to 1

hour, depending on individual circumstances, with an estimated average of .75 hour.

Estimated number of respondents and/or recordkeepers: 4,025,000

Estimated frequency of responses: Annually

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 26 U.S.C. 6103.

Background

Temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** amend 26 CFR part 1 relating to section 179 of the Internal Revenue Code (Code). The temporary regulations provide guidance under section 179 for making and revoking elections to expense the cost of property subject to section 179. 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.

It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact, as discussed earlier in this preamble, that the amount of time necessary to record and retain the required information will be minimal for those taxpayers electing to expense the cost of section 179 property. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, 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 November 30, 2004, beginning at 10 a.m., in room 4718, 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 November 9, 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 Winston H. Douglas, 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 1.179-2 is amended by revising paragraphs (b)(1) and (b)(2)(ii) to read as follows:

§1.179-2 Limitations on amount subject to section 179 election.

* * * * *

(b) * * *

(1) [The text of the proposed amendment to §1.179-2(b)(1) is the same as the text of §1.179-2T(b)(1) published elsewhere in this issue of the **Federal Register**].

(2) * * *

(i) * * *

(ii) [The text of the proposed amendment to §1.179-2(b)(2)(ii) is the same as the text of §1.179-2T(b)(2)(ii) published elsewhere in this issue of the **Federal Register**].

Par. 3. Section 1.179-4 is amended by revising paragraph (a) to read as follows:

§1.179-4 Definitions.

* * * * *

(a) [The text of the proposed amendment to §1.179-4(a) is the same as the text of §1.179-4T(a) published elsewhere in this issue of the **Federal Register**].

* * * * *

Par. 4. Section 1.179-5 is amended by adding paragraph (c) to read as follows:

§1.179-5 Time and manner of making election.

* * * * *

(c) [The text of the proposed amendment of §1.179-5(c) is the same as the text of §1.179-5T(c) published elsewhere in this issue of the **Federal Register**].

Par. 5. Section 1.179-6 is revised to read as follows:

§1.179-6 Effective date.

[The text of the proposed amendment to §1.179-6 is the same as the text of

§1.179-6T published elsewhere in this issue of the **Federal Register**].

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: July 21, 2004.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9146]

RIN 1545-BD35

Section 179 Elections

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations relating to the election to expense the cost of property subject to section 179 of the Internal Revenue Code. The regulations reflect changes to the law made by section 202 of the Jobs and Growth Tax Relief Reconciliation Act of 2003. 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 August 4, 2004.

Applicability Dates: For dates of applicability, see §1.179-6T.

FOR FURTHER INFORMATION CONTACT: Winston H. Douglas, (202) 622-3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public

procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the **Office of Management and Budget** under control number 1545-1201. Responses to this collection of information are required to obtain a benefit.

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.

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

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, Federal tax returns and tax return information are confidential pursuant to 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR part 1 to provide regulations under section 179 of the Internal Revenue Code (Code). These amendments reflect the changes to the law made by section 202 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law 108-27 (117 Stat. 752).

Prior to the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) (117 Stat. 752), section 179 provided that, in lieu of depreciation under section 168 (MACRS depreciation) for taxable years beginning in 2003 and thereafter, a taxpayer with a sufficiently small amount of current year investment in section 179 property could elect to deduct up to $25,000 of the cost of section 179 property placed in service by the taxpayer for the taxable year. In general, section 179 property was defined as depreciable tangible personal property that was purchased for use in the active conduct of a trade or business. The $25,000 amount was reduced (but not below zero) by the amount by which the cost of section 179 property placed in service by the taxpayer during the taxable year exceeded $200,000. The election under section 179 generally was made on the taxpayer's original Federal tax return for the taxable year to which the election related, required specific information to be provided at the time the election was made, and could only be revoked with the consent of the Commissioner of Internal Revenue.

The changes made to section 179 by section 202 of JGTRRA are applicable for section 179 property placed in service by a taxpayer in taxable years beginning after 2002 and before 2006. Section 202 of JGTRRA expands the definition of section 179 property to include off-the-shelf computer software (a category of intangible property) and increases the $25,000 and $200,000 amounts to $100,000 and $400,000, respectively. In addition, the $100,000 and $400,000 amounts are indexed annually for inflation for taxable years beginning after 2003 and before 2006. JGTRRA also modifies section 179 to provide that any election or specification for taxable years

beginning after 2002 and before 2006 may be revoked by the taxpayer with respect to any section 179 property, and that such revocation, once made, shall be irrevocable. The conference agreement (H.R. Conf. Rep. No. 108-126, at 35 (2003)) states that a taxpayer may make or revoke an expensing election on an amended Federal tax return without the consent of the Commissioner.

Explanation of Provisions

For taxable years beginning after 2002 and before 2006, the regulations reflect the change to section 179(d)(1) by including off-the-shelf computer software in the definition of section 179 property, and the changes to sections 179(b)(1) and (2) by increasing the respective amounts to $100,000 and $400,000. The regulations also provide guidance for making and revoking elections under section 179 for those taxable years. Several examples are provided to illustrate how taxpayers may make and revoke their section 179 elections. Additionally, each year the IRS will publish the annual inflation indexed amounts for sections 179(b)(1) and (2). For the inflation indexed amounts for taxable years beginning in 2004, see Rev. Proc. 2003-85, 2003-49 I.R.B. 1184.

Making or Revoking Section 179 Elections on Amended Federal Tax Returns

Prior to the enactment of JGTRRA, an election to expense the cost of property under section 179 generally was made on the taxpayer's original federal tax return for the taxable year to which the election applied. An election could only be revoked with the consent of the Commissioner. The section 179 regulations (pre-JGTRRA) provided that a revocation of an election would only be granted in extraordinary circumstances.

Small business taxpayers are often unaware of the advantages or disadvantages of section 179 expensing. Some taxpayers may not have been aware of the section 179 election until after filing an original Federal tax return. In addition, making the section 179 election is not always to a taxpayer's advantage. For example, the section 179 election may prevent the taxpayer from fully using exemptions and deductions, reduce a taxpayer's coverage under the social security system, and make various tax credits unusable. See Internal Revenue Service, Publication 946, "How to Depreciate Property (For use in preparing 2003 Returns)", p. 14, and "General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals", Department of the Treasury, p. 23 (February 2003).

Permitting taxpayers to make or revoke section 179 elections on amended Federal tax returns without the consent of the Commissioner reflects Congress' intent "that the process of making and revoking section 179 elections should be made simpler and more efficient for taxpayers." H.R. Rep. No. 108-94, at 25 and 26 (2003) and S. Prt. No. 108-26, at 10 (2003). Such a process will provide flexibility to small business taxpayers in determining whether the section 179 election is to their advantage or disadvantage.

Section 1.179-5T(c)(1) establishes the time period during which a taxpayer may make or revoke a section 179 election on an amended Federal tax return.

Section 1.179-5T(c)(2) provides that a section 179 election made on an amended Federal tax return must specify the item of section 179 property to which the election applies and the portion of the cost of each such item to be taken into account under

section 179. Further, if a taxpayer elected to expense only a portion of the cost basis of an item of section 179 property for a particular taxable year (or did not elect to expense any portion of the cost basis of an item of section 179 property), §1.179-5T(c)(2) allows the taxpayer to file an amended Federal tax return and expense any portion of the cost basis of an item of section 179 property that was not expensed pursuant to a prior section 179 election. Any such increase in the amount expensed under section 179 is not deemed to be a revocation of the prior election for that particular taxable year.

Section 1.179-5T(c)(3) provides that any election under section 179, or specification of such election, for any taxable year beginning after 2002 and before 2006 for any item of section 179 property may be revoked by the taxpayer on an amended Federal tax return without the Commissioner's consent and that such revocation, once made, is irrevocable. For this purpose, a specification refers to both the selected specific item of section 179 property subject to a section 179 election and a selected dollar amount allocable to the specific item of section 179 property. In addition, §1.179-5T(c)(3) describes the circumstances under which partial and entire revocations of elections and specifications occur. Section 1.179-5T(c)(3) also discusses the effect of a revocation of an election under section 179 or a revocation of any specification of such election.

Section 1.179-5T(c)(4) sets forth examples illustrating the rules of paragraphs (c)(1), (2), and (3).

Section 1.179-6T provides the applicability dates for the provisions of §§1.179-2T, 1.179-4T, and 1.179-5T.

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 proposed rules section in this issue of 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 Winston H. Douglas, 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

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

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 1.179-0 is amended as follows:

1. Paragraphs (b)(1) and (b)(2) of §1.179-2 are revised.
2. Section 1.179-2T is added.
3. Paragraph (a) of §1.179-4 is revised.
4. Section 1.179-4T is added.
5. Paragraph (c) of §1.179-5 is added.
6. Section 1.179-5T is added.
7. Section 1.179-6T is added.

The revisions and additions read as follows:

§1.179-0 Table of contents for section 179 expensing rules.

* * * * *

§1.179-2 Limitations on amount subject to section 179 election.

* * * * *
(b) * * *
(1) [Reserved].
(2) [Reserved].
* * * * *

§1.179-2T Limitations on amount subject to section 179 election (temporary).

(a) [Reserved].
(b) Dollar Limitation.
(1) In general.
(2) Excess section 179 property.
(3) through (d) [Reserved].
* * * * *

§1.179-4 Definitions.

(a) Section 179 property [Reserved].
* * * * *

§1.179-4T Definitions.

(a) Section 179 property.
(b) through (f) [Reserved].

§1.179-5 Time and manner of making election.

* * * * *

(c) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.

§1.179-5T Time and manner of making election.

(a) and (b) [Reserved].
(c) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.
* * * * *

§1.179-6T Effective dates.

(a) In general.
(b) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.

Par. 3. Section 1.179-2 is amended by revising paragraphs (b)(1) and (b)(2)(ii) to read as follows:

§1.179-2 Limitations on amount subject to section 179 election.

* * * * *

(b) * * *

(1) [Reserved]. For further guidance, see §1.179-2T(b)(1).

(2) * * *

(i) * * *

(ii) [Reserved]. For further guidance, see §1.179-2T(b)(2)(ii).

* * * * *

Par. 4. Section 1.179-2T is added to read as follows:

§1.179-2T Limitations on amount subject to section 179 election (temporary).

(a) [Reserved]. For further guidance, see §1.179-2(a).

(b) Dollar limitation--(1) In general. The aggregate cost of section 179 property that a taxpayer may elect to expense under section 179 for any taxable year beginning in 2003 and thereafter is $25,000 ($100,000 in the case of taxable years beginning after 2002 and before 2006 under section 179(b)(1), indexed annually for inflation under section179(b)(5) for taxable years beginning after 2003 and before 2006), reduced (but not below zero) by the amount of any excess section 179 property (described in paragraph (b)(2) of this section) placed in service during the taxable year.

(b)(2) and (b)(2)(i) [Reserved]. For further guidance, see §1.179-2(b)(2) and (b)(2)(i).

(ii) $200,000 ($400,000 in the case of taxable years beginning after 2002 and before 2006 under section 179(b)(2), indexed annually for inflation under section 179(b)(5) for taxable years beginning after 2003 and before 2006).

(b)(3) through (d) [Reserved]. For further guidance, see §1.179-2(b)(3) through (d).

Par. 5. Section 1.179-4 is amended by revising paragraph (a) to reads as follows:

§1.179-4 Definitions.

* * * * *

(a) [Reserved]. For further guidance, see §1.179-4T(a).

* * * * *

Par. 6. Section 1.179-4T is added to read as follows:

§1.179-4T Definitions (temporary).

The following definitions apply for purposes of section 179, §§1.179-1 through 1.179-6, and §§1.179-2T, 5T, and 6T:

(a) Section 179 property. The term section 179 property means any tangible property described in section 179(d)(1) that is acquired by purchase for use in the active conduct of the taxpayer's trade or business (as described in §1.179-2(c)(6)). For taxable years beginning after 2002 and before 2006, the term section 179 property includes computer software described in section 179(d)(1) that is placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006 and is acquired by purchase for use in the active conduct of the taxpayer's trade or business (as described in §1.179-2(c)(6)). For purposes of this paragraph (a), the term trade or business has the same meaning as in section 162 and the regulations thereunder.

(b) through (f) [Reserved]. For further guidance, see §1.179-4(b) through (f).

Par. 7. Section 1.179-5 is amended by adding paragraph (c) to read as follows:

§1.179-5 Time and manner of making election.

* * * * *

(c) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006. [Reserved]. For further guidance, see §1.179-

5T(c).

Par. 8. Section 1.179-5T is added to read as follows:

§1.179-5T Time and manner of making election (temporary).

(a) and (b) [Reserved]. For further guidance, see §1.179-5(a) and (b).

(c) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006--(1) In general. For any taxable year beginning after 2002 and before 2006, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for such taxable year.

(2) Election--(i) In general. For any taxable year beginning after 2002 and before 2006, a taxpayer is permitted to make an election under section 179 on an amended Federal tax return for that taxable year without the consent of the Commissioner. Thus, the election under section 179 and §1.179-1 to claim a section 179 expense deduction for section 179 property may be made on an amended Federal tax return for the taxable year to which the election applies. The amended Federal tax return must include the adjustment to taxable income for the section 179 election and any collateral adjustments to taxable income or to the tax liability (for example, the amount of depreciation allowed or allowable in that taxable year for the item of section 179 property to which the election pertains). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years.

(ii) Specifications of election. Any election under section 179 must specify the items of section 179 property and the portion of the cost of each such item to be taken into account under section 179(a). Any election under section 179 must comply with the specification requirements of section 179(c)(1)(A), §1.179-1(b), and §1.179-5(a). If a taxpayer elects to expense only a portion of the cost basis of an item of section 179 property for a taxable year beginning after 2002 and before 2006 (or did not elect to expense any portion of the cost basis of the item of section 179 property), the taxpayer is permitted to file an amended Federal tax return for that particular taxable year and increase the portion of the cost of the item of section 179 property to be taken into account under section 179(a) (or elect to expense any portion of the cost basis of the item of section 179 property if no prior election was made) without the consent of the Commissioner. Any such increase in the amount expensed under section 179 is not deemed to be a revocation of the prior election for that particular taxable year.

(3) Revocation--(i) In general. Section 179(c)(2) permits the revocation of an entire election or specification, or a portion of the selected dollar amount of a specification. The term specification in section 179(c)(2) refers to both the selected specific item of section 179 property subject to a section 179 election and the selected dollar amount allocable to the specific item of section 179 property. Any portion of the cost basis of an item of section 179 property subject to an election under section 179 for a taxable year beginning after 2002 and before 2006 may be revoked by the taxpayer without the consent of the Commissioner by filing an amended Federal tax return for that particular taxable year. The amended Federal tax return must include the

adjustment to taxable income for the section 179 revocation and any collateral adjustments to taxable income or to the tax liability (for example, allowable depreciation in that taxable year for the item of section 179 property to which the revocation pertains). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years. Reducing or eliminating a specified dollar amount for any item of section 179 property with respect to any taxable year beginning after 2002 and before 2006 results in a revocation of that specified dollar amount.

(ii) Effect of revocation. Such revocation, once made, shall be irrevocable. If the selected dollar amount reflects the entire cost of the item of section 179 property subject to the section 179 election, a revocation of the entire selected dollar amount is treated as a revocation of the section 179 election for that item of section 179 property and the taxpayer is unable to make a new section 179 election with respect to that item of property. If the selected dollar amount is a portion of the cost of the item of section 179 property, revocation of a selected dollar amount shall be treated as a revocation of only that selected dollar amount. The revoked dollars cannot be the subject of a new section 179 election for the same item of property.

(4) Examples. The following examples illustrate the rules of this paragraph (c):

Example 1. Taxpayer, a sole proprietor, owns and operates a jewelry store. During 2003, Taxpayer purchased and placed in service two items of section 179 property – a cash register costing $4,000 (5-year MACRS property) and office furniture costing $10,000 (7-year MACRS property). On his 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 the full cost of the cash register and, with respect to the office furniture, claimed the depreciation allowable. In November 2004, Taxpayer determines it would have been more advantageous to have made an election under section 179 to expense the full cost of the office furniture rather than the cash register. Pursuant to paragraph (c)(1) of this section, Taxpayer is permitted to file an amended Federal tax return for 2003 revoking the section 179

election for the cash register, claiming the depreciation allowable in 2003 for the cash register, and making an election to expense under section 179 the cost of the office furniture. The amended return must include an adjustment for the depreciation previously claimed in 2003 for the office furniture, an adjustment for the depreciation allowable in 2003 for the cash register, and any other collateral adjustments to taxable income or to the tax liability. In addition, once Taxpayer revokes the section 179 election for the entire cost basis of the cash register, Taxpayer can no longer expense under section 179 any portion of the cost of the cash register.

Example 2. Taxpayer, a sole proprietor, owns and operates a machine shop that does specialized repair work on industrial equipment. During 2003, Taxpayer purchased and placed in service one item of section 179 property – a milling machine costing $135,000. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 $5,000 of the cost of the milling machine and claimed allowable depreciation on the remaining cost. Subsequently, Taxpayer determines it would have been to Taxpayer's advantage to have elected to expense $100,000 of the cost of the milling machine on Taxpayer's 2003 Federal tax return. In November 2004, Taxpayer files an amended Federal tax return for 2003, increasing the amount of the cost of the milling machine that is to be taken into account under section 179(a) to $100,000, decreasing the depreciation allowable in 2003 for the milling machine, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(2)(ii) of this section, increasing the amount of the cost of the milling machine to be taken into account under section 179(a) supplements the portion of the cost of the milling machine that was already taken into account by the original section 179 election made on the 2003 Federal tax return and no revocation of any specification with respect to the milling machine has occurred.

Example 3. Taxpayer, a sole proprietor, owns and operates a real estate brokerage business located in a rented storefront office. During 2003, Taxpayer purchases and places in service two items of section 179 property – a laptop computer costing $2,500 and a desktop computer costing $1,500. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 the full cost of the laptop computer and the full cost of the desktop computer. Subsequently, Taxpayer determines it would have been to Taxpayer's advantage to have originally elected to expense under section 179 only $1,500 of the cost of the laptop computer on Taxpayer's 2003 Federal tax return. In November 2004, Taxpayer files an amended Federal tax return for 2003 reducing the amount of the cost of the laptop computer that was taken into account under section 179(a) to $1,500, claiming the depreciation allowable in 2003 on the remaining cost of $1,000 for that item, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(3)(ii) of this section, the $1,000 reduction represents a revocation of a portion of the selected dollar amount and no portion of those revoked dollars may be the subject of a new section 179 election for the laptop computer.

Example 4. Taxpayer, a sole proprietor, owns and operates a furniture making business. During 2003, Taxpayer purchases and places in service one item of section 179 property – an industrial-grade cabinet table saw costing $5,000. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 $3,000 of the cost of the saw and, with respect to the remaining $2,000 of the cost of the saw, claimed the depreciation allowable. In November 2004, Taxpayer files an amended Federal tax return for 2003 revoking the selected $3,000 amount for the saw, claiming the depreciation allowable in 2003 on the $3,000 cost of the saw, and making any other collateral adjustments to taxable income or to the tax liability. Subsequently, in December 2004, Taxpayer files a second amended Federal tax return for 2003 selecting a new dollar amount of $2,000 for the saw, including an adjustment for the depreciation previously claimed in 2003 on the $2,000, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(2)(ii) of this section, Taxpayer is permitted to select a new selected dollar amount to expense under section 179 encompassing all or a part of the initially non-elected portion of the cost of the elected item of section 179 property. However, no portion of the revoked $3,000 may be the subject of a new section 179 dollar amount selection for the saw. In December 2005, Taxpayer files a third amended Federal tax return for 2003 revoking the entire selected $2,000 amount with respect to the saw, claiming the depreciation allowable in 2003 for the $2,000, and making any other collateral adjustments to taxable income or to the tax liability. Because Taxpayer elected to expense, and subsequently revoke, the entire cost basis of the saw, the section 179 election for the saw has been revoked and Taxpayer is unable to make a new section 179 election with respect to the saw.

Par. 9. Section 1.179-6T is added to read as follows:

§1.179-6T Effective dates.

(a) In general. Except as provided in paragraph (b) of this section, the provisions of §§1.179-1 through 1.179-5 apply for property placed in service by the taxpayer in taxable years ending after January 25, 1993. However, a taxpayer may apply the provisions of §§1.179-1 through 1.179-5 to property placed in service by the taxpayer after December 31, 1986, in taxable years ending on or before January 25, 1993. Otherwise, for property placed in service by the taxpayer after December 31, 1986, in taxable years ending on or before January 25, 1993, the final regulations under section 179 as in effect for the year the property was placed in service apply, except to

the extent modified by the changes made to section 179 by the Tax Reform Act of 1986 (100 Stat. 2085), the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342) and the Revenue Reconciliation Act of 1990 (104 Stat. 1388-400). For that property, a taxpayer may apply any reasonable method that clearly reflects income in applying the changes to section 179, provided the taxpayer consistently applies the method to the property.

(b) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006. The provisions of §§1.179-2T, 1.179-4T, and 1.179-5T, reflecting changes made to section 179 by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (117 Stat. 752), apply for property placed in service in taxable years beginning after 2002 and before 2006.

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

Par. 10. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 11. In §602.101, paragraph (b) is amended by adding the following entries in numerical order to the table to read as follows:

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 3, 2004
JS-1832

Secretary Snow Visits Ohio and Pennsylvania This Week to Meet with Business Leaders on the Economy

U.S. Treasury Secretary John W. Snow will visit Akron, Ohio on Thursday, August 5 and Pittsburgh, Pennsylvania on Friday, August 6 to meet with local business leaders and discuss the President's efforts to strengthen the economy and create jobs.

"As a result of the President's tax reform and economic policies, more than 1.5 million new U.S. jobs have been created since August 2003, including nearly 1.3 million that were created this year," said Secretary Snow. "So far this year, Pennsylvania has gained more than 59,000 new jobs, while Ohio has gained close to 18,000."

The President's tax reform policies have ensured that more than 4.4 million Ohio taxpayers and more than 4.6 million Pennsylvania taxpayers will have lower income tax bills in 2004.

The following events are open to the media, which must present media credentials or photo ID.

Thursday, August 5

Tour of InfoCision
10:00 am EDT
InfoCision
325 Springside Drive
Akron, OH
** Media should arrive by 9:15 am
** A brief press availability will occur immediately following the tour
** Media contact at InfoCision is Tina Boyes at 330-670-5180.

Roundtable Discussion with Local Business Leaders
11:30 am – 12:00 pm EDT
University of Akron's Goodyear Polymer Center
11th Floor
170 University Avenue
Akron, OH
** The first 30 minutes of the roundtable are open to the media, followed by a closed-press luncheon.
** Media contact at University of Akron is Bruce Vernyi at 330-972-6477 or bvernyi@uakron.edu.

Friday, August 6

Remarks to Pittsburgh Technology Council
8:00 am EDT
Renaissance Pittsburgh Hotel
107 Sixth Street
Pittsburgh, PA
** Media should arrive by 7:15 am
** Media should RSVP to Kevin Lane at the Pittsburgh Technology Council at 412-

687-0200 or klane@pghtech.org

Tour of MEDRAD and Roundtable Discussion with Local Business Leaders
10:00 am EDT
MEDRAD, Inc.
1 MEDRAD Drive
Indianola, PA
**** A brief press availability will occur immediately following the event**

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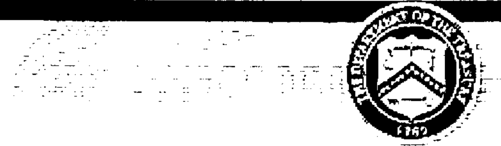


PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 3, 2004
JS-1833

Secretary Snow to Visit Wall Street

Treasury Chief Will Applaud the Women and Men of the Financial Services Industry and Discuss Efforts to Strengthen and Protect Our Critical Financial Infrastructure

U.S. Treasury Secretary John W. Snow will visit New York City on Wednesday, August 4, to spend time with the employees of the New York Stock Exchange (NYSE) and thank them for their commitment to keeping the nation's financial systems strong during this period of increased threat level.

"Thanks to the workers at NYSE, Citibank and many other entities, our nation's financial markets and financial institutions continue to operate normally. I want the financial community to know how much their commitment to their work is valued," Secretary Snow said. "Their dedication is the reason our financial system is so strong and resilient, and a reminder of why people around the world rightly have so much confidence in U.S. financial markets."

The Secretary also plans to discuss the coordinated efforts of the government and private sector to keep our financial infrastructure strong and functioning, now and in the event of any potential market disruptions. "The Treasury Department has been and is currently in close cooperation with the Department of Homeland Security, other federal, state and local financial regulators, the international financial institutions, and the private sector to strengthen and protect our critical financial infrastructure," Secretary Snow said. "The level of cooperation is evident in the success of this week's response to the increased terror alert."

The following event is open to the press, which must wear media credentials or ID:

Secretary Snow tours the NYSE
Wednesday August 4, 2004
1:00pm
IMPORTANT: Media interested in covering Secretary Snow MUST contact Jolene Libretto 212-656-2705 in order to obtain entry into the building and must arrive ½ hour in advance at the security checkpoint at Exchange & Broad Streets.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

June 29, 2004
JS-1835

Remarks at Independence Day Celebration
Under Secretary John B. Taylor
Inter-America Development Bank
Washington, DC
June 29, 2004

Thank you Hector Morales. We are grateful to you and the staff of the US Executive Director's office for all of your hard work to represent the United States at the IDB. Thanks also to Enrique Iglesias for your leadership at the IDB and for the excellent work you and your staff are doing.

As you are well-aware, the government of the United States of America under President Bush's and Secretary Snow's leadership has been especially active in our economic dialogue with Latin America and the Caribbean this year, beginning with the Special Summit of the Americas in January, our continuing progress in the Group for Growth with Brazil, and in the Partnership for Prosperity, which concluded today in Mexico. And, just last week Secretary Snow met with President Lula and Minister Palocci where our bilateral Group for Growth was highlighted.

The global economy is the strongest it has been in many years, led by strong growth and job creation in the United States. Latin America is fully participating in this global recovery, thanks to good economic policies in many parts of the region. I've had the opportunity to visit several regional countries this year and I continue to be impressed by the many government initiatives throughout Latin America and the Caribbean that are pursuing productivity-led growth, consolidating fiscal responsibility, and improving transparency for the benefit of their citizens.

In 2003, six of the region's seven largest economies increased primary budget surpluses to bring down debt levels and reduced or maintained low inflation. Growth in 2003 was at or near four percent in countries from Peru to Colombia to Costa Rica.

And growth is accelerating in 2004. Mexico grew at a five percent pace in the first quarter of 2004; growth in Argentina, Brazil, and Chile was above six percent. The United States has worked closely with its partners in the region to stabilize their economies in the wake of the difficulties of 2001-2 to pave the way for this return to growth; we are committed to continuing this work by supporting efforts throughout the region to remove the impediments to higher economic growth over the long term.

The IDB plays a fundamental role in the process.

In addition to its important lending and grant activities to the public and private sectors, in the last year we've also seen the IDB play a key role in the region's economic development through its commitments at the Summit of the Americas, particularly in the areas of remittances and expanding credit to small businesses.

The leadership of the G7 has recognized the important work on remittance at the IDB and, in particular, the Multilateral Investment Fund under Don Terry's leadership. Indeed, the example has been expanded into a global initiative to reduce the cost of sending remittances. We also appreciate the good work on

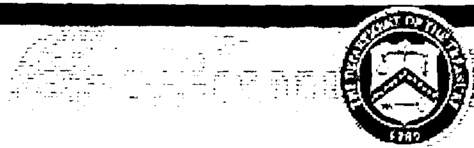
financing for small businesses at the IDB.

The US has also recognized this work and has indicated our willingness to begin negotiations on a replenishment of the Multilateral Investment Fund (MIF).

So, we look forward to seeing the results of these activities, and to witnessing the benefits of economic development reach more and more citizens of Latin America and the Caribbean.

Thank you very much, for coming to this Independence Day Celebration. Happy Birthday United States of America.

I did not know you would be handing out American flags today, so I brought my own American flag. I must say that I took this flag (which I wave here today as you wave your flags) out of a small box which I keep in my office in the U.S. Treasury. The box is labeled "The Under Secretary's First Aid Kit." The kit was given to me by former Secretary of Treasury and State George Shultz as I was moving into this job about three and half years ago. It's for emergencies. For example, it includes a pair of dice to roll when a tough decision must be made. And it includes a blind fold! The flag is for days when patriotism is called for. And today is one of those days when I want to be patriotic. And, again, Happy Birthday United States of America.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 10, 2004
JS-1836

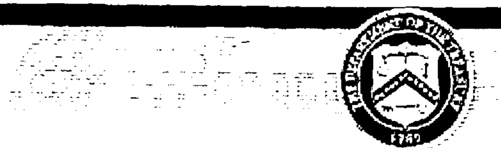
Under Secretary Visit to Dominican Republic
Statement by John B. Taylor
Under Secretary of Treasury for International Affairs
Santo Domingo, Dominican Republic
July 10, 2004

It is a pleasure to be here in the Dominican Republic once again. My visit – as my previous trip to Santo Domingo in November 2003 – reflects the strong interest that the United States takes in the well-being of this country and its citizens. The United States has strongly supported the Mejia administration in its efforts to overcome the economic difficulties of the past year. We look forward to working closely with the incoming Fernandez administration on its agenda for restoring economic stability and growth.

When I visited last November, the focus was on stabilizing the economic situation through the election period. At that time, deeper reforms – in areas like tax policy – were intentionally deferred until after the elections, so that the post-election political consensus could shape their content. Now that the elections are over, it is time for the country's new leadership to bring together all elements of Dominican society to tackle these core fiscal, monetary, debt, and regulatory issues.

I have had the opportunity to meet with a broad range of people during my trip, including President Mejia and his economic team, Vice President-elect Albuquerque and President-elect Fernandez's transition team, members of the business community, and Congressional leaders. I am impressed by the good cooperation that is taking place between the outgoing and incoming administrations. This cooperation is essential – not only for facilitating a smooth executive transition, but also because addressing the economic challenges that the Dominican Republic faces requires cooperation from across the political spectrum. Everyone – citizens, businesspeople, and political leaders alike – must do their part to advance the reforms upon which the country's future prosperity depends.

The United States stands ready to work with the Dominican Republic on these efforts.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

July 9, 2004
JS-1837

Under Secretary Visit to Haiti
Statement by John B. Taylor
Under Secretary for International Affairs, U.S. Department of the Treasury
Port au Prince, Haiti
July 9, 2004

Good morning and thank you for joining me today.

I am very pleased to be visiting Haiti at this important time. President Bush takes a strong interest in seeing Haiti succeed. During my visit, I was impressed by the steps that the government of Haiti is taking to improve the lives of its citizens after a very difficult period.

The United States has been working with our partners in the international community to support the efforts of the government. Over the past few weeks, donors have come together to produce a comprehensive needs assessment to help guide development activities. Later this month a group of donor countries and organizations will meet in Washington to raise funding to jumpstart economic reconstruction, increase economic growth, create jobs, and raise living standards in Haiti.

It is important that donors and the Haitian government not repeat the mistakes of the past, when large commitments of funding failed to generate improvements in the lives of the Haitian people. The United States is committed to working with the government and the international community to make sure that this time projects in all sectors have concrete targets and timelines designed to produce tangible results for Haiti's people.

This morning I met with Prime Minister Latortue – with whom I met previously in Washington – and he updated me on the reforms his administration is undertaking. I congratulated the Prime Minister on his administration's leadership in collecting revenues and managing the government's fiscal affairs responsibly, without recourse to inflationary financing that has been so destructive in the past. The Prime Minister also underlined his commitment to fighting corruption, increasing transparency, and expediting the execution of development projects.

The Prime Minister and I also discussed the importance of the role of the private sector in Haiti – a topic I also had the opportunity to discuss with representatives of the business community as well as with the finance minister, the planning minister, and the central bank governor. There is general agreement that while it is essential to address Haiti's urgent social needs, raising living standards requires job creation. Only businesses themselves can create the jobs that lift families out of poverty. The government must do its part to create an environment that encourages entrepreneurs and small businesses by simplifying regulation, promoting a strong financial sector that broadens access to credit, and investing in infrastructure.

Improving Haiti's road network was frequently mentioned as a high priority. I am certain that this objective will be a focus for donors as we meet to discuss Haiti's funding needs later this month. Clearly, transportation systems are vitally important for a country's economic growth, allowing goods to get to market, children to get to

school, and people to get to jobs and access services, as efficiently and safely as possible.

Before I leave, I will also visit a World Bank health project in the pediatrics center in the Port-au-Prince General Hospital, which provides grant assistance to treat malnutrition in infants and children. This project shows the kind of visible impact that grants can have in meeting urgent needs.

The people of Haiti deserve a chance to experience the benefits of economic growth. Because of mistakes in the past, Haiti has lagged behind its neighbors. The United States looks forward to working with the people of Haiti to make the best of this new opportunity.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 5, 2004
JS-1838

Treasury and IRS Provide Guidance on Allocation of Earnings of Controlled Foreign Corporations

Today the Treasury Department and the Internal Revenue Service issued proposed regulations providing guidance for determining a U.S. shareholder's pro rata share of the income of a controlled foreign corporation that the shareholder must include in gross income for U.S. tax purposes under the subpart F rules.

These proposed regulations are intended to update the existing regulations in this area, which date back to 1965, to reflect the increased complexity of international business arrangements. "The proposed regulations provide results that are more consistent with the economic interests of shareholders in a controlled foreign corporation," said Greg Jenner, Acting Assistant Secretary for Tax Policy.

In particular, the proposed regulations provide detailed rules for determining a U.S. shareholder's pro rata share of subpart F amounts when the controlled foreign corporation has multiple classes of stock outstanding and the distribution of earnings among two or more classes of stock depends upon the exercise of discretion by the board of directors or similar governing body of the corporation. For purposes of determining a U.S. shareholder's pro rata share, classes of stock with such discretionary distribution rights are taken into account based on their relative value.

The proposed regulations also provide that restrictions or limitations on the distribution of earnings to a U.S. shareholder that are structured by the corporation or its shareholders (e.g., as part of the terms of a class of stock or through other arrangements) generally are not be taken into account in determining a U.S. shareholder's pro rata share of subpart F amounts, subject to certain specified exceptions.

When issued in final form, the regulations will be effective for taxable years beginning on or after January 1, 2005.

REPORTS

- The text of the proposed regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-129771-04]

RIN 1545-BD49

TITLE: Guidance under section 951 for determining pro rata share.

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 951(a) of the Internal Revenue Code (Code) that provide guidance for determining a United States shareholder's pro rata share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from foreign base company shipping operations, and amounts determined under section 956.

DATES: Written or electronic comments must be received by November 8, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 18, 2004, at 10 a.m. must be received by November 4, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-129771-04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-129771-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet

site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-129771-04). If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jonathan A. Sambur, (202) 622-3840; 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

This document contains proposed amendments to 26 CFR part 1 under section 951(a) of the Code relating to the determination of a United States shareholder's pro rata share of a CFC's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from foreign base company shipping operations, and amounts determined under section 956 (collectively, section 951(a)(1) amounts).

In general, section 951(a)(1) requires a United States shareholder that owns stock in a CFC to include its pro rata share of such section 951(a)(1) amounts in its gross income. Pro rata share is defined in section 951(a)(2) of the Code as the amount:

> (A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a [CFC] it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a [CFC] bears to the entire year, reduced by
>
> (B) the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the

corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year.

The current regulations provide rules for determining a United States shareholder's pro rata share of a CFC's section 951(a)(1) amounts in the case where the CFC has more than one class of stock outstanding. These regulations have remained unchanged since 1965. In the 39 years since the rules were issued, international business arrangements have become much more complex than contemplated in 1965, reflecting in particular more complex structures for determining return on capital. The current regulations do not take into account these developments. The IRS and Treasury, therefore, believe that updated guidance is necessary to ensure results that are more consistent with the economic interests of shareholders in a CFC.

Explanation of Provisions

A. In General

Section 1.951-1(e) defines pro rata share for purposes of section 951(a) of the Code. These proposed regulations replace existing §1.951-1(e)(2) through (4) and are intended to provide allocations that are more consistent with the economic interests of shareholders in a CFC. The proposed regulations also include a conforming change to §1.951-1(e)(1) to reflect the 1993 legislative amendment to section 956 of the Code.

B. Pro Rata Share Rules for CFCs with Only One Class of Stock

Proposed §1.951-1(e)(2) adds an explicit rule to clarify the method by which a United States shareholder's pro rata share of a CFC's section 951(a)(1) amounts is determined in the case where the CFC has only one class of stock outstanding. In such a case, each United States shareholder's share of the CFC's section 951(a)(1) amounts

shall be determined on a per share basis. Example 1 of proposed §1.951-1(e)(6) illustrates the application of this rule.

C. Pro Rata Share Rules for CFCs with More than One Class of Stock

1. In General

Proposed §1.951-1(e)(3) provides rules for determining a United States shareholder's pro rata share of a CFC's section 951(a)(1) amounts in the case where the CFC has more than one class of stock outstanding. Proposed §1.951-1(e)(3)(i) retains the general rule in the current regulations, which provides that the amount of subpart F income, withdrawals, or amounts determined under section 956 which shall be taken into account with respect to any one class of stock shall be that amount which bears the same ratio to the total of such subpart F income, withdrawals, or amounts determined under section 956 for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year on which such corporation is a CFC (the hypothetical distribution date) bear to the total earnings and profits of such corporation for such taxable year. Examples 2 and 8 of proposed §1.951-1(e)(6) illustrate the application of this general rule.

This general rule applies in cases where a CFC has more than one class of stock outstanding and where the allocation of the amount of the CFC's earnings and profits between or among different classes of stock does not depend upon the exercise of discretion by the board of directors or similar governing body of the CFC. The IRS and Treasury Department believe that this general rule, in practice, will apply in most cases in which a CFC has more than one class of stock outstanding.

2. Discretionary Power to Allocate Earnings to Different Classes of Stock

In the case where the allocation of the amount of a CFC's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by the board of directors or a similar governing body of the CFC, proposed §1.951-1(e)(3)(ii)(A) provides a new general rule that determines the pro rata share of the CFC's section 951(a)(1) amounts. This new general rule allocates earnings and profits to classes of shares with discretionary distribution rights by reference to the relative values of such classes of shares on the hypothetical distribution date. Under this new rule, the allocation of earnings and profits to each class of stock with discretionary distribution rights generally will be the amount of earnings and profits that bears the same ratio to the total earnings and profits allocated to all classes of stock with discretionary distribution rights as the value of all shares of such class determined on the hypothetical distribution date bears to the total value of all classes of stock with discretionary distribution rights. This allocation approach is analogous to the approach used for allocating adjustments among classes of stock for consolidated return purposes. See §1.1502-32(c). For guidance with respect to the valuation of stock, see, e.g., Framatome Connectors USA, Inc. v. Comm'r, 118 T.C. 32 (2002) (establishing factors to be used to value stock of a CFC for purposes of determining whether the foreign corporation was a CFC pursuant to the value test in section 957(a)(2)); compare Rev. Rul. 59-60, 1959-1 C.B. 237 (valuing privately held stock for estate tax purposes). See §601.601(d)(2)(ii)(b). In cases where the value of each share of two or more classes of stock with discretionary distribution rights is substantially the same, the allocation of earnings and profits to each class of stock shall be made as if such classes

constituted one class of stock. Examples 3 and 4 of proposed §1.951-1(e)(6) illustrate the application of these rules.

The general rules of proposed §1.951-1(e)(3)(i) and (ii)(A) both apply in certain cases where a CFC has more than two classes of stock outstanding. Specifically, these rules both apply where a CFC has at least two classes of stock with discretionary distribution rights and at least one class of stock with non-discretionary distribution rights. In general, a United States shareholder's pro rata share of a CFC's section 951(a)(1) amounts is determined by allocating earnings and profits to classes of shares with non-discretionary distribution rights (e.g., nonparticipating preferred stock) in accordance with the rules of proposed paragraph (e)(3)(i), and then allocating the remaining earnings and profits, if any, to each remaining class of stock in accordance with the relative value rules of proposed paragraph (e)(3)(ii)(A).

The new rule in proposed §1.951-1(e)(3)(ii)(A) is intended to ensure that the determination of a United States shareholder's pro rata share of a CFC's section 951(a)(1) amounts in cases where the United States shareholder's stock has discretionary distribution rights properly reflects the true economics of the shareholder's investment in the CFC. The IRS and Treasury Department believe that in the case of multiple classes of stock with discretionary distribution rights, the relative value of the classes of stock better reflects the economics of the investment in a CFC, and thus provides a better mechanism for determining a United States shareholder's pro rata share of a CFC's section 951(a)(1) amounts.

Proposed §1.951-1(e)(3)(ii)(B) provides that the right to redeem stock of a CFC will not be considered a discretionary distribution right for purposes of determining a

shareholder's pro rata share under proposed §1.951-1(e)(3)(ii)(A), even if the resulting redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d). Example 7 of proposed §1.951-1(e)(6) illustrates the application of this rule.

3. Special Allocation Rule for Stock with Mixed Distribution Rights

Proposed §1.951-1(e)(3)(iii) provides a specific rule that appies the general rules of proposed §1.951-1(e)(3)(i) and (ii)(A) in cases where a class of stock provides for both non-discretionary distribution rights and discretionary distribution rights (e.g., participating preferred stock). In such a case, the proposed regulations require separate allocations of earnings and profits based upon the non-discretionary distribution rights and the relative value of the discretionary distribution rights. Example 5 of proposed §1.951-1(e)(6) illustrates the application of this rule.

4. Dividend Arrearages

Proposed §1.951-1(e)(3)(iv) retains the existing rule with respect to arrearages in dividends with respect to classes of preferred stock of the CFC. The earnings and profits for the taxable year shall be attributable to such arrearage only to the extent the arrearage exceeds the earnings and profits remaining from prior taxable years beginning after December 31, 1962.

D. Scope of Deemed Distribution.

Proposed §1.951-1(e)(4) sets forth a special rule that provides that no amount shall be considered to be distributed with respect to a particular class of stock under proposed §1.951-1(e)(3) to the extent that such a distribution would constitute a distribution in redemption of stock, a distribution in liquidation, or a return of capital.

This rule would apply notwithstanding the terms of any class of stock of the CFC or any arrangement involving the CFC. Thus, for purposes of determining the allocation of earnings and profits to a class of stock of a CFC based on the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits were distributed pro rata to its shareholders on the hypothetical distribution date, taxpayers may not consider any part of the hypothetical distribution as a distribution in redemption of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)), a distribution in liquidation, or a return of capital. The IRS and Treasury Department believe that such characterizations of the hypothetical distribution would not properly reflect a United States shareholder's economic interest in the CFC and thus should not be considered in determining a United States shareholder's pro rata share of section 951(a)(1) amounts. Example 7 of proposed §1.951-1(e)(6) illustrates the application of this rule.

E. Restrictions or Other Limitations on Distributions of Earnings and Profits by a CFC

Proposed §1.951-1(e)(5) provides that, except in the case of a governmental restriction described in section 964(b) of the Code, a restriction or other limitation on the distribution of earnings and profits to a United States shareholder by a CFC will not be taken into account for purposes of determining the amount of earnings and profits allocated to a class of stock of a CFC or the amount of the United States shareholder's pro rata share of the CFC's section 951(a)(1) amounts. This rule applies in all cases, including cases where the restriction or limitation is the result of an arrangement between unrelated parties or an arrangement that has a non-tax motivated business purpose and economic substance. The IRS and Treasury Department believe that

taking into account such restrictions or limitations in determining a United States shareholder's pro rata share is contrary to the purpose of section 951(a) and would not properly reflect a United States shareholder's economic interest in the CFC. Example 6 of proposed §1.951-1(e)(6) illustrates the application of this rule.

Proposed §1.951-1(e)(5)(ii) provides a broad definition of restrictions or other limitations on distributions that are covered by this rule. Under proposed §1.951-1(e)(5)(iii), the right to receive a preferred dividend is not considered a restriction or other limitation on the distribution of earnings and profits with respect to other classes of stock. Proposed §1.951-1(e)(5)(iv) lists some instances where restrictions or other limitations will not be taken into account.

Proposed Effective Date

These regulations are proposed to apply for taxable years of a controlled foreign corporation beginning on or after January 1, 2005.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, 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 (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing has been scheduled for November 18, 2004, at 10 a.m. 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. 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 written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 4, 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.

Comments are requested on all aspects of the proposed regulations, including those aspects for which specific requests for comments are set forth above.

Drafting Information

The principal author of these regulations is Jonathan A. Sambur, Office of Associate Chief Counsel (International). 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 continues to read, in part, as follows:

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

Par. 2. Section 1.951-1 is amended by:

1. Removing the language "increase in earnings invested in United States property" in paragraph (e)(1) and adding "amount determined under section 956" in its place.

2. Revising paragraphs (e)(2) through (e)(4) and adding paragraphs (e)(5) through (e)(7) to read as follows:

§1.951-1 Amounts included in gross income of United States shareholders.

* * * * *

(e) * * *

(2) One class of stock. If a controlled foreign corporation for a taxable year has only one class of stock outstanding, each United States shareholder's pro rata share of

such corporation's subpart F income, withdrawal, or amount determined under section 956, for the taxable year under paragraph (e)(1) of this section shall be determined by allocating the controlled foreign corporation's earnings and profits on a per share basis.

(3) More than one class of stock--(i) In general. Subject to paragraphs (e)(3)(ii) and (e)(3)(iii) of this section, if a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income, withdrawal, or amount determined under section 956, for the taxable year taken into account with respect to any one class of stock for purposes of paragraph (e)(1) of this section shall be that amount which bears the same ratio to the total of such subpart F income, withdrawal, or amount determined under section 956 for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year on which such corporation is a controlled foreign corporation (the hypothetical distribution date), bear to the total earnings and profits of such corporation for such taxable year.

(ii) Discretionary power to allocate earnings to different classes of stock--(A) In general. Subject to paragraph (e)(3)(iii) of this section, the rules of this paragraph apply for purposes of paragraph (e)(1) if the allocation of a controlled foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the powers ordinarily exercised by the board of directors of a domestic corporation (discretionary distribution rights). First, the earnings and profits of the corporation are allocated under paragraph (e)(3)(i) of this section to any class or

classes of stock with non-discretionary distribution rights (e.g., preferred stock entitled to a fixed return). Second, the amount of earnings and profits allocated to a class of stock with discretionary distribution rights shall be that amount which bears the same ratio to the remaining earnings and profits of such corporation for such taxable year as the value of all shares of such class of stock, determined on the hypothetical distribution date, bears to the total value of all shares of all classes of stock with discretionary distribution rights of such corporation, determined on the hypothetical distribution date. For purposes of the preceding sentence, in the case where the value of each share of two or more classes of stock with discretionary distribution rights is substantially the same on the hypothetical distribution date, the allocation of earnings and profits to such classes shall be made as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share.

(B) Special rule for redemption rights. For purposes of paragraph (e)(3)(ii)(A) of this section, discretionary distribution rights do not include rights to redeem shares of a class of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)).

(iii) Special allocation rule for stock with mixed distribution rights. For purposes of paragraphs (e)(3)(i) and (e)(3)(ii) of this section, in the case of a class of stock with both discretionary and non-discretionary distribution rights, earnings and profits shall be allocated to the non-discretionary distribution rights under paragraph (e)(3)(i) of this section and to the discretionary distribution rights under paragraph (e)(3)(ii) of this section. In such a case, paragraph (e)(3)(ii) of this section will be applied such that the

value used in the ratio will be the value of such class of stock solely attributable to the discretionary distribution rights of such class of stock.

(iv) Dividend arrearages. For purposes of paragraph (e)(3)(i) of this section, if an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962.

(4) Scope of deemed distribution. Notwithstanding the terms of any class of stock of the controlled foreign corporation or any agreement or arrangement with respect thereto, no amount shall be considered to be distributed with respect to a particular class of stock for purposes of paragraph (e)(3) of this section to the extent that such distribution would constitute a distribution in redemption of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)), as a distribution in liquidation, or as a return of capital.

(5) Restrictions or other limitations on distributions--(i) In general. A restriction or other limitation on distributions of earnings and profits by a controlled foreign corporation will not be taken into account, for purposes of this section, in determining the amount of earnings and profits that shall be allocated to a class of stock of the controlled foreign corporation or the amount of the United States shareholder's pro rata share of the controlled foreign corporation's subpart F income, withdrawal, or amounts determined under section 956 for the taxable year.

(ii) Definition. For purposes of this section, a restriction or other limitation on distributions includes any limitation that has the effect of limiting the allocation or distribution of earnings and profits by a controlled foreign corporation to a United States shareholder, other than currency or other restrictions or limitations imposed under the laws of any foreign country as provided in section 964(b).

(iii) Exception for certain preferred distributions. The right to receive periodically a fixed amount (whether determined by a percentage of par value, a reference to a floating coupon rate, a stated return expressed in terms of a certain amount of dollars or foreign currency, or otherwise) with respect to a class of stock the distribution of which is a condition precedent to a further distribution of earnings or profits that year with respect to any class of stock (not including a distribution in partial or complete liquidation) is not a restriction or other limitation on the distribution of earnings and profits by a controlled foreign corporation under paragraph (e)(5) of this section.

(iv) Illustrative list of restrictions and limitations. Except as provided in paragraph (e)(5)(iii) of this section, restrictions or other limitations on distributions include, but are not limited to--

(A) An arrangement that restricts the ability of the controlled foreign corporation to pay dividends on a class of shares of the corporation owned by United States shareholders until a condition or conditions are satisfied (e.g., until another class of stock is redeemed);

(B) A loan agreement entered into by a controlled foreign corporation that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied; or

(C) An arrangement that conditions the ability of the controlled foreign corporation to pay dividends to its shareholders on the financial condition of the controlled foreign corporation.

(6) Examples. The application of this section may be illustrated by the following examples:

Example 1. (i) Facts. FC1, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of one class of stock. Corp E, a domestic corporation and a United States shareholder of FC1, within the meaning of section 951(b), owns 60 shares. Corp H, a domestic corporation and a United States shareholder of FC1, within the meaning of section 951(b), owns 40 shares. FC1, Corp E, and Corp H each use the calendar year as a taxable year. Corp E and Corp H are shareholders of FC1 for its entire 2004 taxable year. For 2004, FC1 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). FC1 makes no distributions during that year.

(ii) Analysis. FC1 has one class of stock. Therefore, under paragraph (e)(2) of this section, FC1's earnings and profits are allocated on a per share basis. Accordingly, for the taxable year 2004, Corp E's pro rata share of FC1's subpart F income is $60x (60/100 x $100x) and Corp H's pro rata share of FC1's subpart F income is $40x (40/100 x $100x).

Example 2. (i) Facts. FC2, a controlled foreign corporation within the meaning of section 957(a), has outstanding 70 shares of common stock and 30 shares of 4-percent, nonparticipating, voting, preferred stock with a par value of $10x per share. The common shareholders are entitled to dividends when declared by the board of directors of FC2. Corp A, a domestic corporation and a United States shareholder of FC2, within the meaning of section 951(b), owns all of the common shares. Individual B, a foreign individual, owns all of the preferred shares. FC2 and Corp A each use the calendar year as a taxable year. Corp A and Individual B are shareholders of FC2 for its entire 2004 taxable year. For 2004, FC1 has $50x of earnings and profits, and income of $50x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2004, FC2 distributes as a dividend $12x to Individual B with respect to Individual B's preferred shares. FC2 makes no other distributions during that year.

(ii) Analysis. FC2 has two classes of stock, and there are no restrictions or other limitations on distributions within the meaning of paragraph (e)(5) of this section. If the total $50x of earnings were distributed on December 31, 2004, $12x would be distributed with respect to Individual B's preferred shares and the remainder, $38x, would be distributed with respect to Corp A's common shares. Accordingly, under

paragraph (e)(3)(i) of this section, Corp A's pro rata share of FC1's subpart F income is $38x for taxable year 2004.

Example 3. (i) Facts. The facts are the same as in Example 2, except that the shares owned by Individual B are Class B common shares and the shares owned by Corp A are Class A common shares and the board of directors of FC2 may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. The value of the Class A common shares on the last day of FC2's 2004 taxable year is $680x and the value of the Class B common shares on that date is $300x. The board of directors of FC2 determines that FC2 will not make any distributions in 2004 with respect to the Class A and B common shares of FC2.

(ii) Analysis. The allocation of FC2's earnings and profits between its Class A and Class B common shares depends solely on the exercise of discretion by the board of directors of FC2. Therefore, under paragraph (e)(3)(ii)(A) of this section, the allocation of earnings and profits between the Class A and Class B common shares will depend on the value of each class of stock on the last day of the controlled foreign corporation's taxable year. On the last day of FC2's taxable year 2004, the Class A common shares had a value of $9.71x/share and the Class B common shares had a value of $10x/share. Because each share of the Class A and Class B common stock of FC2 has substantially the same value on the last day of FC2's taxable year, under paragraph (e)(3)(ii)(A) of this section, for purposes of allocating the earnings and profits of FC2, the Class A and Class B common shares will be treated as one class of stock. Accordingly, for FC2's taxable year 2004, the earnings and profits of FC2 are allocated $35x (70/100 x $50x) to the Class A common shares and $15x (30/100 x $50x) to the Class B common shares. For its taxable year 2004, Corp A's pro rata share of FC2's subpart F income will be $35x.

Example 4. (i) Facts. FC3, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of Class A common stock, 100 shares of Class B common stock and 10 shares of 5-percent nonparticipating, voting preferred stock with a par value of $50x per share. The value of the Class A shares on the last day of FC3's 2004 taxable year is $800x. The value of the Class B shares on that date is $200x. The Class A and Class B shareholders each are entitled to dividends when declared by the board of directors of FC3, and the board of directors of FC3 may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. Corp D, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the Class A shares. Corp N, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the Class B shares. Corp S, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the preferred shares. FC3, Corp D, Corp N, and Corp S each use the calendar year as a taxable year. Corp D, Corp N, and Corp S are shareholders of FC3 for all of 2004. For 2004, FC3 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2004, FC3 distributes as a

dividend $25x to Corp S with respect to the preferred shares. The board of directors of FC3 determines that FC3 will make no other distributions during that year.

(ii) Analysis. The distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. Pursuant to paragraph (e)(3)(i) of this section, if the total $100x of earnings were distributed on December 31, 2004, $25x would be distributed with respect to Corp S's preferred shares and the remainder, $75x would be distributed with respect to Corp D's Class A shares and Corp N's Class B shares. The allocation of that $75x between its Class A and Class B shares depends solely on the exercise of discretion by the board of directors of FC3. The value of the Class A shares ($8x/share) and the value of the Class B shares ($2x/share) are not substantially the same on the last day of FC3's taxable year 2004. Therefore for FC3's taxable year 2004, under paragraph (e)(3)(ii)(A) of this section, the earnings and profits of FC3 are allocated $60x ($800/$1,000 x $75x) to the Class A shares and $15x ($200/$1,000 x $75x) to the Class B shares. For the 2004 taxable year, Corp D's pro rata share of FC3's subpart F income will be $60x, Corp N's pro rata share of FC3's subpart F income will be $15x and Corp S's pro rata share of FC3's subpart F income will be $25x.

Example 5. (i) Facts. FC4, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of participating, voting, preferred stock and 200 shares of common stock. The owner of a share of preferred stock is entitled to an annual dividend equal to 0.5-percent of FC4's retained earnings for the taxable year and also is entitled to additional dividends when declared by the board of directors of FC4. The common shareholders are entitled to dividends when declared by the board of directors of FC4. The board of directors of FC4 has discretion to pay dividends to the participating portion of the preferred shares (after the payment of the preference) and the common shares. The value of the preferred shares on the last day of FC4's 2004 taxable year is $600x ($100x of this value is attributable to the discretionary distribution rights of these shares) and the value of the common shares on that date is $400x. Corp E, a domestic corporation and United States shareholder of FC4, within the meaning of section 951(b), owns all of the preferred shares. FC5, a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a), owns all of the common shares. FC 4 and Corp E each use the calendar year as a taxable year. Corp E and FC5 are shareholders of FC4 for all of 2004. For 2004, FC4 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2004, FC4's retained earnings are equal to its earnings and profits. FC4 distributes as a dividend $20x to Corp E that year with respect to Corp E's preferred shares. The board of directors of FC4 determines that FC4 will not make any other distributions during that year.

(ii) Analysis. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. The allocation of FC4's earnings and profits between its preferred shares and common shares depends, in part, on the exercise of discretion by the board of directors of FC4 because the preferred shares are shares with both discretionary distribution rights and

non-discretionary distribution rights. Paragraph (e)(3)(i) of this section is applied first to determine the allocation of earnings and profits of FC4 to the non-discretionary distribution rights of the preferred shares. If the total $100x of earnings were distributed on December 31, 2004, $20x would be distributed with respect to the non-discretionary distribution rights of Corp E's preferred shares. Accordingly, $20x would be allocated to such shares under paragraphs (e)(3)(i) and (iii) of this section. The remainder, $80x, would be allocated under paragraph (e)(3)(ii)(A) and (e)(3)(iii) of this section between the preferred and common shareholders by reference to the value of the discretionary distribution rights of the preferred shares and the value of the common shares. Therefore, the remaining $80x of earnings and profits of FC4 are allocated $16x ($100x/$500x x $80x) to the preferred shares and $64x ($400x/$500x x $80) to the common shares. For its taxable year 2004, Corp E's pro rata share of FC4's subpart F income will be $36x ($20x + $16x) .

Example 6. (i) Facts. FC6, a controlled foreign corporation within the meaning of section 957(a), has outstanding 10 shares of common stock and 400 shares of 2-percent nonparticipating, voting, preferred stock with a par value of $1x per share. The common shareholders are entitled to dividends when declared by the board of directors of FC6. Corp M, a domestic corporation and a United States shareholder of FC6, within the meaning of section 951(b), owns all of the common shares. FC7, a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a), owns all of the preferred shares. Corp M and FC7 cause the governing documents of FC6 to provide that no dividends may be paid to the common shareholders until FC6 cumulatively earns $100,000x of income. FC6 and Corp M each use the calendar year as a taxable year. Corp M and FC7 are shareholders of FC6 for all of 2004. For 2004, FC6 has $50x of earnings and profits, and income of $50x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2004, FC6 distributes as a dividend $8x to FC7 with respect to FC7's preferred shares. FC6 makes no other distributions during that year.

(ii) Analysis. The agreement restricting FC6's ability to pay dividends to common shareholders until FC6 cumulatively earns $100,000x of income is a restriction or other limitation, within the meaning of paragraph (e)(5) of this section, and will be disregarded for purposes of calculating Corp M's pro rata share of subpart F income. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. If the total $50x of earnings were distributed on December 31, 2004, $8x would be distributed with respect to FC7's preferred shares and the remainder, $42x, would be distributed with respect to Corp M's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp M's pro rata share of FC6's subpart F income is $42x for taxable year 2004.

Example 7. (i) Facts. FC8, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of common stock and 10 shares of 4-percent voting preferred stock with a par value of $50x per share. Pursuant to the terms of the preferred stock, FC8 has the right to redeem at any time, in whole or in part, the

preferred stock. FP, a foreign corporation, owns all of the preferred shares. Corp G, a domestic corporation wholly owned by FP and a United States shareholder of FC8, within the meaning of section 951(b), owns all of the common shares. FC8 and Corp G each use the calendar year as a taxable year. FP and Corp G are shareholders of FC8 for all of 2004. For 2004, FC8 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholder under section 951(a). In 2004, FC8 distributes as a dividend $20x to FP with respect to FP's preferred shares. FC8 makes no other distributions during that year.

(ii) Analysis. Pursuant to paragraph (e)(3)(ii)(B) of this section, the redemption rights of the preferred shares will not be treated as a discretionary distribution right under paragraph (e)(3)(ii)(A) of this section. Further, if FC8 were treated as having redeemed any preferred shares under paragraph (e)(3)(i) of this section, the redemption would be treated as a distribution to which section 301 applies under section 302(d) due to FP's constructive ownership of the common shares. However, pursuant to paragraph (e)(4) of this section, no amount of earnings and profits would be allocated to the preferred shareholders on the hypothetical distribution date, under paragraph (e)(3)(i) of this section, as a result of FC8's right to redeem, in whole or in part, the preferred shares. FC8's redemption rights with respect to the preferred shares cannot affect the allocation of earnings and profits between FC8's shareholders. Therefore, the redemption rights are not restrictions or other limitations within the meaning of paragraph (e)(5) of this section. Additionally, the non-discretionary distribution rights of the preferred shares are not restrictions or other limitations within the meaning of paragraph (e)(5) of this section. Therefore, if the total $100x of earnings were distributed on December 31, 2004, $20x would be distributed with respect to FP's preferred shares and the remainder, $80x, would be distributed with respect to Corp G's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp G's pro rata share of FC8's subpart F income is $80 for taxable year 2004.

Example 8. (i) Facts. FC9, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, nonvoting, preferred stock with a par value of $100x per share. Individual J, a United States shareholder of FC9, within the meaning of section 951(b), who uses the calendar year as a taxable year, owns 30 shares of the common stock, and 15 shares of the preferred stock during tax year 2004. The remaining 10 common shares and 45 preferred shares of FC9 are owned by Foreign Individual N, a foreign individual. Individual J and Individual N are shareholders of FC9 for all of 2004. For taxable year 2004, FC9 has $1,000x of earnings and profits, and income of $500x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a).

(ii) Analysis. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. If the total $1,000x of earnings and profits were distributed on December 31, 2004, $360x (0.06 x $100x x 60) would be distributed with respect to FC9's preferred stock

and $640x ($1,000x minus $360x) would be distributed with respect to its common stock. Accordingly, of the $500x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a), $180x ($360x/$1,000x x $500x) is allocated to the outstanding preferred stock and $320x ($640x/$1,000x x $500x) is allocated to the outstanding common stock. Therefore, under paragraph (e)(3)(i) of this section, Individual J's pro rata share of such amounts for 2004 is $285x [($180x x 15/60)+($320x x 30/40)].

(7) Effective date. These regulations apply for taxable years of a controlled foreign corporation beginning on or after January 1, 2005.

Nancy Jardini

Acting Deputy Commissioner for Services and Enforcement.

Approved: July 16, 2004

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 5, 2004
JS-1839

Treasury and IRS Issue New Regulations on Source of Compensation for Labor or Personal Services

Today Treasury and the IRS issued proposed regulations for determining the source of compensation for labor or personal services. The new rules apply to individuals who, as employees, perform labor or personal services partly within and partly outside the United States. In connection with the issuance of the new proposed regulations, Treasury and the IRS are withdrawing regulations that had been proposed in 2000.

"These new regulations provide clear and straightforward rules for determining the source of employee compensation income in the cross-border context. At the same time, they provide much needed flexibility that will allow taxpayers and the IRS to take into account specific circumstances in order to reach the right result," said Greg Jenner, Acting Assistant Secretary for Tax Policy. "This approach will reduce disputes between taxpayers and the IRS and to allow more efficient use of IRS resources."

Current regulations provide that in cases where a person performs labor or personal services partly within and partly outside the United States, the amount that is treated as income from United States sources is determined under the facts and circumstances of the particular case. Regulations proposed in 2000 would have required that the source of compensation received by any individual for a specific time period be determined solely based on the portion of the time worked within and without the United States. The regulations proposed today generally provide that in the case of an individual who receives compensation as an employee, identified fringe benefits are sourced on a geographic basis and all other compensation is sourced on a time basis.

The proposed regulations also provide for the opportunity, in appropriate circumstances, to use a different approach to determine the source of compensation received by an individual as an employee. The regulations proposed today would retain the current-law rule providing that the source of compensation for labor or personal services that is received by a corporation or an individual who is not an employee is determined under the facts and circumstances of the particular case.

REPORTS

- The text of the proposed regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-208254-90]; [REG-136481-04]

RIN 1545-AO72; RIN 1545-BD62

Source of Compensation for Labor or Personal Services

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking and notice of proposed rulemaking.

SUMMARY: This document contains new proposed rules that describe the proper basis for determining the source of compensation from labor or personal services performed partly within and partly without the United States. The new proposed rules will affect individuals that earn compensation from labor or personal services performed partly within and partly without the United States and are needed to provide appropriate guidance regarding the determination of the proper source of that compensation. This document also withdraws the notice of proposed rulemaking (REG-208254-90) published in the **Federal Register** on January 21, 2000 (65 FR 3401).

DATES: Written or electronic comments and requests for a public hearing must be received by November 4, 2004. The notice of proposed rulemaking published on January 21, 2000, is withdrawn as of August 6, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-208254-90), 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-208254-90), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington DC or sent electronically, via the IRS Internet site at: www.irs.gov/regs or Federal eRulemaking Portal at www.regulations.gov (IRS and REG-208254-90).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David Bergkuist, (202) 622-3850 (not a toll-free number); concerning the submissions of comments, Lanita Van Dyke (202) 622-7180, (not a toll-free number).

SUPPLEMENTARY INFORMATION

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have 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(d)). Comments on the collections 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 October 5, 2004. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collections 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 collections 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 in this proposed regulation are in §1.861-4(b)(2)(ii)(C)(1)(i), (b)(2)(ii)(D), and (b)(2)(ii)(D)(6). The information required in §1.861-4(b)(2)(ii)(C)(1)(i) will enable an individual, where appropriate, to use an alternative basis other than that described in §1.861-4(b)(2)(ii)(A) or (B) to determine the source of his or her compensation as an employee for labor or personal services performed partly within and partly without the United States. The information required in §1.861-4(b)(2)(ii)(D) and (D)(6) will enable an employee to source certain fringe benefits on a geographical basis. The collections of information will, likewise, allow the IRS to verify these determinations.

The collections of information and responses to these collections of information are required to obtain and maintain benefits. The likely respondents are individuals who perform labor or personal services partly within and partly without the United States, some of which may receive certain fringe benefit compensation for those services.

Estimated total annual recordkeeping burden: 10,000 hours.

The estimated annual burden per recordkeeper varies from 15 minutes to one hour, depending on the circumstances of the individual, with an estimated average of 30 minutes.

Estimated number of recordkeepers: 20,000.

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 26 U.S.C. 6103.

Background

This document contains proposed amendments (the new proposed regulations) 26 CFR part 1 under section 861 of the Internal Revenue Code (Code). On January 21, 2000, a notice of proposed rulemaking was published in the **Federal Register** at 65 FR 3401 [REG-208254-90; 2000-1 C.B. 577] (the previously proposed regulations). The previously proposed regulations would have modified the existing final regulations relating to the determination of the source of income from the performance of labor or

personal services performed partly within and partly without the United States. Written comments were received in response to the notice of proposed rulemaking. A public hearing was held on July 18, 2000. In response to these comments, and after further consideration of the issue, the previously proposed regulations are withdrawn and new regulations are proposed. This preamble discusses comments received on the previously proposed regulations and describes the differences between the new proposed regulations and the previously proposed regulations.

Explanation of Provisions

The existing final regulations, §1.861-4(b), provide that if a person performs labor or personal services partly within and partly without the United States, the amount to be included in gross income from United States sources shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.

The previously proposed regulations retained the facts and circumstances basis for determining the source of such income for persons other than individuals. For individuals, however, the previously proposed regulations provided that if an individual received compensation for a specific time period for labor or personal services that are performed partly within and partly without the United States, the amount of compensation for labor or personal services performed within the United States would have been determined solely on a time basis.

Several comments questioned the rule in the previously proposed regulations that required individuals to determine the source of such income on a time basis. In response to those comments, and after further consideration of the issues presented,

the previously proposed regulations are withdrawn and new regulations are proposed that take into account the concerns raised.

Treasury and the IRS believe that a time basis generally is the most appropriate method for determining the source of an individual employee's compensation for labor and personal services performed partly within and partly without the United States. Compensation provided to an employee for a specific time period is generally considered to be earned by the employee ratably over that time period. Accordingly, it is appropriate generally to source such compensation on a ratable basis. In addition, Treasury and the IRS believe that this rule will provide certainty and simplification for both taxpayers and the IRS. The information necessary to apply the time basis should be readily available to employers and employees. For example, Form 2555, "Foreign Earned Income", requires an individual who claims the foreign earned income exclusion to provide the IRS with information relating to the number ofbusiness days spent within the United States and any fringe benefits received. Sourcing on a time basis may be appropriate as well for individuals other than employees who receive compensation for labor or personal services and who may be viewed as earni ng such compensation ratably.

Nonetheless, for entities other than individuals and for individuals who are not employees, the facts and circumstances in many cases may be such that an apportionment on a basis other than a time basis may be more appropriate. For example, a corporation could receive payments under a contract for services to be performed by numerous employees at various pay levels in a number of different geographic locations. In such a case, payroll costs under the contract for services, or

another basis besides time, may more correctly reflect the proper source of the corporation's income.

The new proposed regulations retain the facts and circumstances basis as the general rule for determining the source of compensation for labor and personal services performed partly within and partly without the United States received by persons other than individuals and by individuals who are not employees. However, the new proposed regulations provide two new general bases for determining the proper source of compensation that an individual receives as an employee for such labor or personal services. Under the first general basis of §1.861-4(b)(2)(ii)(A), an individual who receives compensation, other than compensation in the form of certain fringe benefits, as an employee for labor or personal services performed partly within and partly without the United States is required to source such compensation on a time basis, as defined in §1.861-4(b)(2)(ii)(E).

Under the second general basis of §1.861-4(b)(2)(ii)(B) and (D), an individual who receives compensation as an employee for labor or personal services performed partly within and partly without the United States in the form of fringe benefits, as described in §1.861-4(b)(2)(ii)(D)(1) through (6), is required to source such compensation on a geographical basis (*e.g.*, at the employee's principal place of work, as defined in section 217 and §1.217-2(c)(3)). The fringe benefits to which this general basis applies are: housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay, and moving expense reimbursement fringe benefits. This general basis will apply only if the amount of the fringe benefit is reasonable and is substantiated by adequate contemporaneous records or sufficient evidence under rules

similar to those set forth in §1.274-5T(c) or (h) or §1.132-5, and only if the fringe benefit meets the definition set forth in the new proposed regulations. Treasury and the IRS intend to keep the list and descriptions of identified fringe benefits current and invite comments regarding whether the identified fringe benefits are appropriately defined and whether other fringe benefits should be identified in the regulations and sourced on a specific geographic basis.

Treasury and the IRS recognize that there are circumstances in which these two general bases may not be the most appropriate basis for determining the source of an employee's compensation for labor or personal services performed partly within and partly without the United States. Accordingly, the new proposed regulations at §1.861-4(b)(2)(ii)(C)(1)(i) provide that an employee may use an alternative basis, based upon the facts and circumstances, to source such compensation if he or she establishes to the satisfaction of the Commissioner that such an alternative basis more properly determines the source of the compensation. For example, when an employee's compensation is tied to the performance of specific actions rather than earned ratably over a specific time period, an alternative basis may more properly determine the source of compensation than the bases for determining source of compensation described in §1.861-4(b)(2)(ii)(A) and (B).

In order to satisfy the Commissioner, an employee must retain in his or her records documentation setting forth why the alternative basis more properly determines the source of the compensation than the basis for determining source of compensation described in §1.861-4(b)(2)(ii)(A) or (B). In addition, it is anticipated that the Commissioner, by ruling or other administrative pronouncement, will issue guidance as

to what procedures an employee must follow in order to assert an alternative basis to determine the source of his or her compensation for labor or personal services performed partly within and partly without the United States. Such administrative pronouncement will likely require that an individual who has $250,000 or more in compensation for the tax year must indicate in the manner prescribed that he or she is using an alternative basis to source his or her compensation. Such individual may be required to file a form, or retain the following in his or her records: (1) a written explanation of why the alternative basis more properly determines the source of the compensation than the basis for determining source of compensation described in §1.861-4(b) (2)(ii)(A) or (B) under the facts and circumstances, and (2) a written comparison of the dollar amount of the compensation sourced within and without the United States under both the individual's alternative basis and the basis for determining source of compensation described in §1.861-4(b)(2)(ii)(A) or (B).

Section 1.861-4(b)(2)(ii)(C)(1)(ii) of the new proposed regulations also provides that the Commissioner may, under the facts and circumstances of the particular case, determine the source of compensation that is received by an individual as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis other than a basis described in paragraph (b)(2)(ii)(A) or (B) if such compensation either (1) is not for a specific time period or (2) constitutes in substance a fringe benefit described in paragraph (b)(2)(ii)(D) notwithstanding a failure to meet any requirement of paragraph (b)(2)(ii)(D). The Commissioner may make this determination only if such alternative basis determines the source of

compensation in a more reasonable manner than the basis used by the individual pursuant to paragraph (b)(2)(ii)(A) or (B).

Section 1.861-4(b)(2)(ii)(C)(2) of the new proposed regulations provides that the Commissioner may, by ruling or other administrative pronouncement applying to similarly situated taxpayers generally, permit individuals to determine the source of their compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis. Any such individual shall be treated as having met the requirement to establish such alternative basis to the satisfaction of the Commissioner under the facts and circumstances of the particular case, provided that the individual meets the other requirements of paragraph (b)(2)(ii)(C)(1)(i). This paragraph also provides that the Commissioner may, by ruling or other administrative pronouncement, indicate the circumstances in which he will require individuals to determine the source of certain compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis pursuant to the authority under paragraph (b)(2)(ii)(C)(1)(ii) of this section.

Section 1.861-4(b)(2)(ii)(C)(3) of the new proposed regulations is reserved with respect to artists and athletes who are employees. It is intended that the specific rules for artists and athletes who are employees will require such individuals to determine the proper source of compensation for labor or personal services on the basis that most correctly reflects the proper source of that income under the facts and circumstances of the particular case, consistent with current law. Comments are invited in this connection, including on the proper definition of an artist or athlete for this purpose.

Examples illustrating these new rules with respect to compensation that an individual receives as an employee are included in §1.861-4(b)(2)(ii)(G) of the new proposed regulations.

Several of the comments to the previously proposed regulations requested specific rules for compensation arrangements that relate to services performed over a period of more than one year, such as employee stock option plans, transfers of restricted property, and other deferred compensation arrangements. The new proposed regulations provide at §1.861-4(b)(2)(ii)(F) that the source of multi-year compensation of an employee is generally determined on a time basis over the applicable period to which the compensation is attributable. Determination of the applicable period to which the compensation is attributable (including whether the compensation relates to more than one taxable year) is based upon the facts and circumstances of the particular case. Treasury and the IRS invite taxpayers to provide comments on whether alternative bases for determining the source of such multi-year compensation are appropriate.

One comment questioned whether a day was the only time period upon which to apply the time basis of sourcing compensation. In response to this comment, the new proposed regulations provide at §1.861-4(b)(2)(ii)(E) that, although the time basis is generally determined by comparing the number of days of performance of the labor or personal services by the individual within the United States to his or her total number of days of performance of labor or personal services, use of a unit of time less than a day may be appropriate for purposes of this calculation. For example, it may be more appropriate to source compensation paid to an airline flight crewmember based on a time unit of less than a day.

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

Comments and Requests for a Public Hearing

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

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of a 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 January 21, 2000, (65 CFR 3401), REG-208254-90 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 1.861-4 is amended as follows:

1. The heading for paragraph (a) is revised.

2. A sentence is added at the beginning of paragraph (a)(1).

3. Paragraph (b) is revised.

4. A sentence is added at the end of paragraph (d).

The revisions and addition read as follows:

§1.861-4 Compensation for labor or personal services.

(a) Compensation for labor or personal services performed wholly within the United States--(1) Generally, compensation for labor or personal services, including fees, commissions, fringe benefits, and similar items, performed wholly within the United States is gross income from sources within the United States. * * *

(b) Compensation for labor or personal services performed partly within and partly without the United States--(1) Compensation for labor or personal services performed by persons other than individuals--(i) In general. In the case of compensation for labor or personal services performed partly within and partly without the United States by a person other than an individual, the part of that compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on the basis that most correctly reflects the proper source of the

income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on the time basis, as defined in paragraph (b)(2)(ii)(E) of this section, will be acceptable.

(ii) Example. Corp X, a domestic corporation, receives compensation of $150,000 under a contract for services to be performed concurrently in the United States and in several foreign countries by numerous Corp X employees. Each Corp X employee performing services under this contract performs his or her services exclusively in one jurisdiction. Although the number of employees (and hours spent by employees) performing services under the contract within the United States equals the number of employees (and hours spent by employees) performing services under the contract without the United States, the compensation paid to employees performing services under the contract within the United States is higher because of the more sophisticated nature of the services performed by the employees within the United States. Accordingly, the payroll cost for employees performing services under the contract within the United States is $20,000 out of a total contract payroll cost of $30,000. Under these facts and circumstances, a determination based upon relative payroll costs would be the basis that most correctly reflects the proper source of the income received under the contract. Thus, of the $150,000 of compensation included in Corp X's gross income, $100,000 ($150,000 x $20,000/$30,000) is attributable to the labor or personal services performed within the United States and $50,000 ($150,000 X $10,000/$30,000) is attributable to the labor or personal services performed without the United States.

(2) Compensation for labor or personal services performed by an individual--(i) In general. Except as provided in paragraph (b)(2)(ii) of this section, in the case of compensation for labor or personal services performed partly within and partly without the United States by an individual, the part of such compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on the basis that most correctly reflects the proper source of that income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section, will be acceptable.

(ii) Employee compensation--(A) In general. Except as provided in paragraph (b)(2)(ii)(B) or (C) of this section, in the case of compensation for labor or personal services performed partly within and partly without the United States by an individual as an employee, the part of such compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section.

(B) Certain fringe benefits sourced on a geographical basis. Except as provided in paragraph (b)(2)(ii)(C) of this section, items of compensation of an individual as an employee for labor or personal services performed partly within and partly without the United States that are described in paragraph (b)(2)(ii)(D)(1) through (6) of this section are sourced on a geographical basis in accordance with those paragraphs.

(C) Exceptions and special rules--(1) Alternative basis--(i) Individual as an employee generally. An individual may determine the source of his or her compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis if the individual establishes to the satisfaction of the Commissioner that, under the facts and circumstances of the particular case, the alternative basis more properly determines the source of the compensation than a basis described in paragraph (b)(2)(ii)(A) or (B), whichever is applicable, of this section. An individual that uses an alternative basis must retain in his or her records documentation setting forth why the alternative basis more properly determines the source of the compensation. In addition, the individual

must comply with the requirements set forth in any applicable administrative pronouncement issued by the Commissioner.

(ii) Determination by Commissioner. The Commissioner may, under the facts and circumstances of the particular case, determine the source of compensation that is received by an individual as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis other than a basis described in paragraph (b)(2)(ii)(A) or (B) of this section if such compensation either is not for a specific time period or constitutes in substance a fringe benefit described in paragraph (b)(2)(ii)(D) of this section notwithstanding a failure to meet any requirement of paragraph (b)(2)(ii)(D) of this section. The Commissioner may make this determination only if such alternative basis determines the source of compensation in a more reasonable manner than the basis used by the individual pursuant to paragraph (b)(2)(ii)(A) or (B) of this section.

(2) Ruling or other administrative pronouncement with respect to groups of taxpayers. The Commissioner may, by ruling or other administrative pronouncement applying to similarly situated taxpayers generally, permit individuals to determine the source of their compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis. Any such individual shall be treated as having met the requirement to establish such alternative basis to the satisfaction of the Commissioner under the facts and circumstances of the particular case, provided that the individual meets the other requirements of paragraph (b)(2)(ii)(C)(1)(i) of this section. The Commissioner also may, by ruling or other administrative pronouncement, indicate the circumstances in which he will require

individuals to determine the source of certain compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis pursuant to the authority under paragraph (b)(2)(ii)(C)(1)(ii) of this section.

(3) Artists and athletes. [RESERVED.]

(D) Fringe benefits sourced on a geographical basis. Except as provided in paragraph (b)(2)(ii)(C) of this section, compensation of an individual as an employee for labor or personal services performed partly within and partly without the United States in the form of the following fringe benefits is sourced on a geographical basis as indicated in this paragraph (b)(2)(ii)(D). The amount of the compensation in the form of the fringe benefit must be reasonable, and the individual must substantiate such amounts by adequate records or by sufficient evidence under rules similar to those set forth in §1.274-5T(c) or (h) or §1.132-5. For purposes of this paragraph (b)(2)(ii)(D), the term principal place of work has the same meaning that it has for purposes of section 217 and §1.217-2(c)(3).

(1) Housing fringe benefit. The source of compensation in the form of a housing fringe benefit is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(1), a housing fringe benefit includes payments to or on behalf of an individual (and the individual's family if the family resides with the individual) only for rent, utilities (other than telephone charges), real and personal property insurance, occupancy taxes not deductible under section 164 or 216(a), nonrefundable fees paid for securing a leasehold, rental of furniture and accessories, household repairs, residential parking, and the fair rental value of housing

provided in kind by the individual's employer. A housing fringe benefit does not include payments for expenses or items set forth in §1.911-4(b)(2).

(2) Education fringe benefit. The source of compensation in the form of an education fringe benefit for the education expenses of the individual's dependents is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(2), an education fringe benefit includes payments only for qualified tuition and related expenses of the type described in section 530(b)(4)(A)(i) and expenditures for room and board and uniforms as described in section 530(b)(4)(A)(ii) with respect to education at an elementary or secondary educational institution.

(3) Local transportation fringe benefit. The source of compensation in the form of a local transportation fringe benefit is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(3), an individual's local transportation fringe benefit is the amount that the individual receives as compensation for local transportation of the individual or the individual's spouse or dependents at the location of the individual's principal place of work. The amount treated as a local transportation fringe benefit is limited to the actual expenses incurred for local transportation and the fair rental value of any vehicle provided by the employer and used predominantly by the individual or the individual's spouse or dependents for local transportation. For this purpose, actual expenses incurred for local transportation do not include the cost (including interest) of the purchase by the individual, or on behalf of the individual, of an automobile or other vehicle.

(4) Tax reimbursement fringe benefit. The source of compensation in the form of a foreign tax reimbursement fringe benefit is determined based on the location of the jurisdiction that imposed the tax for which the individual is reimbursed.

(5) Hazardous or hardship duty pay fringe benefit. The source of compensation in the form of a hazardous or hardship duty pay fringe benefit is determined based on the location of the hazardous or hardship duty zone for which the hazardous or hardship duty pay fringe benefit is paid. For purposes of this paragraph (b)(2)(ii)(D)(5), a hazardous or hardship duty zone is any place in a foreign country which is either designated by the Secretary of State as a place where living conditions are extraordinarily difficult, notably unhealthy, or where excessive physical hardships exist, and for which a post differential of 15 percent or more would be provided under section 5925(b) of Title 5 of the U.S. Code to any officer or employee of the U.S. Government present at that place, or where a civil insurrection, civil war, terrorism, or wartime conditions threatens physical harm or imminent danger to the health and well-being of the individual. Compensation provided an employee during the period that the employee performs labor or personal services in a hazardous or hardship duty zone may be treated as a hazardous or hardship duty pay fringe benefit only if the employer provides the hazardous or hardship duty pay fringe benefit only to employees performing labor or personal services in a hazardous or hardship duty zone. The amount of compensation treated as a hazardous or hardship duty pay fringe benefit may not exceed the maximum amount that the U. S. government would allow its officers or employees present at that location.

(6) Moving expense reimbursement fringe benefit. Except as otherwise provided in this paragraph (b)(2)(ii)(D)(6), the source of compensation in the form of a moving expense reimbursement is determined based on the location of the employee's new principal place of work. The source of such compensation is determined based on the location of the employee's former principal place of work, however, if the individual provides sufficient evidence that such determination of source is more appropriate under the facts and circumstances of the particular case. For purposes of this paragraph (b)(2)(ii)(D)(6), sufficient evidence generally requires an agreement, between the employer and the employee, or a written statement of company policy, which is reduced to writing before the move and which is entered into or established to induce the employee or employees to move to another country. The writing must state that the employer will reimburse the employee for moving expenses that the employee incurs to return to the employee's former principal place of work regardless of whether he or she continues to work for the employer after returning to that location. The writing may contain certain conditions upon which the right to reimbursement is determined as long as those conditions set forth standards that are definitely ascertainable and can only be fulfilled prior to, or through completion of, the employee's return move to the employee's former principal place of work.

(E) Time basis. The amount of compensation for labor or personal services performed within the United States determined on a time basis is the amount that bears the same relation to the individual's total compensation as the number of days of performance of the labor or personal services by the individual within the United States bears to his or her total number of days of performance of labor or personal services. A

unit of time less than a day may be appropriate for purposes of this calculation. The time period for which the compensation for labor or personal services is made is presumed to be the calendar year in which the labor or personal services are performed, unless the taxpayer establishes to the satisfaction of the Commissioner, or the Commissioner determines, that another distinct, separate, and continuous period of time is more appropriate. For example, a transfer during a year from a position in the United States to a foreign posting that lasted through the end of that year would generally establish two separate time periods within that taxable year. The first of these time periods would be the portion of the year preceding the start of the foreign posting, and the second of these time periods would be the portion of the year following the start of the foreign posting. However, in the case of a foreign posting that requires short-term returns to the United States to perform services for the employer, such short-term returns would not be sufficient to establish distinct, separate, and continuous time periods within the foreign posting time period but would be relevant to the allocation of compensation relating to the overall time period. In each case, the source of the compensation on a time basis is based upon the number of days (or unit of time less than a day, if appropriate) in that separate time period.

(F) Multi-year compensation arrangements. The source of multi-year compensation is determined generally on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section, over the period to which such compensation is attributable. For purposes of this paragraph (b)(2)(ii)(F), multi-year compensation means compensation that is included in the income of an individual in one taxable year but that is attributable to a period that includes two or more taxable years. The determination of

the period to which such compensation is attributable, for purposes of determining its source, is based upon the facts and circumstances of the particular case. For example, an amount of compensation that specifically relates to a period of time that includes several calendar years is attributable to the entirety of that multi-year period. The amount of such compensation that is treated as from sources within the United States is the amount that bears the same relationship to the total multi-year compensation as the number of days (or unit of time less than a day, if appropriate) that labor or personal services were performed within the United States in connection with the project bears to the total number of days (or unit of time less than a day, if appropriate) that labor or personal services were performed in connection with the project. In the case of stock options, the facts and circumstances generally will be such that the applicable period to which the compensation is attributable is the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (the vesting of the option).

(G) Examples. The following examples illustrate the application of this paragraph (b)(2)(ii):

Example 1. B, a nonresident alien individual, was employed by Corp M, a domestic corporation, from March 1 to December 25 of the taxable year, a total of 300 days, for which B received compensation in the amount of $80,000. Under B's employment contract with Corp M, B was subject to call at all times by Corp M and was in a payment status on a 7-day week basis. Pursuant to that contract, B performed services (or was available to perform services) within the United States for 180 days and performed services (or was available to perform services) without the United States for 120 days. None of B's $80,000 compensation was for fringe benefits as identified in paragraph (b)(2)(ii)(D) of this section. B determined the amount of compensation that is attributable to his labor or personal services performed within the United States on a time basis under paragraph (b)(2)(ii)(A) and (E) of this section. B did not assert, pursuant to paragraph (b)(2)(ii)(C)(1)(i) of this section, that, under the particular facts and circumstances, an alternative basis more properly determines the source of that compensation than the time basis. Therefore, B must include in income from sources

within the United States $48,000 ($80,000 x 180/300) of his compensation from Corporation M.

Example 2. (i) Same facts as in Example 1 except that Corp M had a company-wide arrangement with its employees, including B, that they would receive an education fringe benefit, as described in paragraph (b)(2)(ii)(D)(2) of this section, while working in the United States. During the taxable year, B incurred education expenses for his dependent daughter that qualified for the education fringe benefit in the amount of $10,000, for which B received a reimbursement from Corp M. B did not maintain adequate records or sufficient evidence of this fringe benefit as required by paragraph (b)(2)(ii)(D) of this section. When B filed his Federal income tax return for the taxable year, B did not apply paragraphs (b)(2)(ii)(B) and (D)(2) of this section to treat the compensation in the form of the education fringe benefit as income from sources within the United States, the location of his principal place of work during the 300-day period. Rather, B combined the $10,000 reimbursement with his base compensation of $80,000 and applied the time basis of paragraph (b)(2)(ii)(A) of this section to determine the source of his gross income.

(ii) On audit, B argues that because he failed to substantiate the education fringe benefit in accordance with paragraph (b)(2)(ii)(D) of this section, his entire employment compensation from Corp M is sourced on a time basis pursuant to paragraph (b)(2)(ii)(A) of this section. The Commissioner, after reviewing Corp M's fringe benefit arrangement, determines, pursuant to paragraph (b)(2)(ii)(C)(1)(ii) of this section, that the $10,000 educational expense reimbursement constitutes in substance a fringe benefit described in paragraph (b)(2)(ii)(D)(2) of this section, notwithstanding a failure to meet all of the requirements of paragraph (b)(2)(ii)(D) of this section, and that an alternative geographic source basis, under the facts and circumstances of this particular case, is a more reasonable manner to determine the source of the compensation than the time basis used by B.

Example 3. (i) A, a United States citizen, is employed by Corp N, a domestic corporation. A's principal place of work is in the United States. A earns an annual salary of $100,000. During the first quarter of the calendar year (which is also A's taxable year), A performed services entirely within the United States. At the beginning of the second quarter of the calendar year, A was transferred to Country X for the remainder of the year and received, in addition to her annual salary, $30,000 in fringe benefits that are attributable to her new principal place of work in Country X. Corp N paid these fringe benefits separately from A's annual salary. Corp N supplied A with a statement detailing that $25,000 of the fringe benefit was paid for housing, as defined in paragraph (b)(2)(ii)(D)(1) of this section, and $5,000 of the fringe benefit was paid for local transportation, as defined in paragraph (b)(2)(ii)(D)(3) of this section. None of the local transportation fringe benefit is excluded from the employee's gross income as a qualified transportation fringe benefit under section 132(a)(5). Under A's employment contract, A was required to work on a 5-day week basis, Monday through Friday. During the last three quarters of the year, A performed services 30 days in the United States and 150 days in Country X and other foreign countries.

(ii) A determined the source of all of her compensation from Corp N pursuant to paragraph (b)(2)(ii)(A), (B), and (D)(1) and (3) of this section. A did not assert, pursuant to paragraph (b)(2)(ii)(C)(1)(i) of this section, that, under the particular facts and circumstances, an alternative basis more properly determines the source of that compensation than the bases set forth in paragraphs (b)(2)(ii)(A), (B), and (D)(1) and (3) of this section. However, in applying the time basis set forth in paragraph (b)(2)(ii)(E) of this section, A establishes to the satisfaction of the Commissioner that the first quarter of the calendar year and the last three quarters of the calendar year are two separate, distinct, and continuous periods of time. Accordingly, $25,000 of A's annual salary is attributable to the first quarter of the year (25 percent of $100,000). This amount is entirely compensation that was attributable to the labor or personal services performed within the United States and is, therefore, included in gross income as income from sources within the United States. The balance of A's compensation as an employee of Corp N, $105,000 (which includes the $30,000 in fringe benefits that are attributable to the location of A's principal place of work in Country X), is compensation attributable to the final three quarters of her taxable year. During those three quarters, A's periodic performance of services in the United States does not result in distinct, separate, and continuous periods of time. Of the $75,000 paid for annual salary, $12,500 (30/180 x $75,000) is compensation that was attributable to the labor or personal services performed within the United States and $62,500 (150/180 x $75,000) is compensation that was attributable to the labor or personal services performed outside the United States. Pursuant to paragraphs (b)(2)(ii)(B) and (D)(1) and (3) of this section, A sourced the $25,000 received for the housing fringe benefit and the $5,000 received for the local transportation fringe benefit based on the location of her principal place of work, Country X. Accordingly, A included the $30,000 in fringe benefits in her gross income as income from sources without the United States.

Example 4. Same facts as in Example 3. Of the 150 days during which A performed services in Country X and in other foreign countries (during the final three quarters of A's taxable year), she performed 30 days of those services in Country Y. Country Y is a country designated by the Secretary of State as a place where living conditions are extremely difficult, notably unhealthy, or where excessive physical hardships exist and for which a post differential of 15 percent or more would be provided under section 5925(b) of Title 5 of the U.S. Code to any officer or employee of the U.S. government present at that place. Corp N has a policy of paying its employees a $65 premium per day for each day worked in countries so designated. The $65 premium per day does not exceed the maximum amount that the U. S. government would pay its officers or employees stationed in Country Y. Because A performed services in Country Y for 30 days, she earned additional compensation of $1,950. The $1,950 is considered a hazardous duty or hardship pay fringe benefit and is sourced under paragraphs (b)(2)(ii)(B) and (D)(5) of this section based on the location of the hazardous or hardship duty zone, Country Y. Accordingly, A included the amount of the hazardous duty or hardship pay fringe benefit ($1,950) in her gross income as income from sources without the United States.

Example 5. (i) During 2006 and 2007, Corp P, a domestic corporation,

employed four United States citizens, E, F, G, and H to work in its manufacturing plant in Country V. As part of his or her compensation package, each employee arranged for local transportation unrelated to Corp P's business needs. None of the local transportation fringe benefit is excluded from the employee's gross income as a qualified transportation fringe benefit under section 132(a)(5) and (f).

(ii) Under the terms of the compensation package that E negotiated with Corp P, Corp P permitted E to use an automobile owned by Corp P. In addition, Corp P agreed to reimburse E for all expenses incurred by E in maintaining and operating the automobile, including gas and parking. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(3) of this section, E's compensation with respect to the fair rental value of the automobile and reimbursement for the expenses E incurred is sourced under paragraphs (b)(2)(ii)(B) and (D)(3) of this section based on E's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in E's gross income as income from sources without the United States.

(iii) Under the terms of the compensation package that F negotiated with Corp P, Corp P let F use an automobile owned by Corp P. However, Corp P did not agree to reimburse F for any expenses incurred by F in maintaining and operating the automobile. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(3) of this section, F's compensation with respect to the fair rental value of the automobile is sourced under paragraphs (b)(2)(ii)(B) and (D)(3) of this section based on F's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in F's gross income as income from sources without the United States.

(iv) Under the terms of the compensation package that G negotiated with Corp P, Corp P agreed to reimburse G for the purchase price of an automobile that G purchased in Country V. Corp P did not agree to reimburse G for any expenses incurred by G in maintaining and operating the automobile. Because the cost to purchase an automobile is not a local transportation fringe benefit as defined in paragraph (b)(2)(ii)(D)(3) of this section, the source of the compensation to G will be determined pursuant to paragraph (b)(2)(ii)(A) or (C) of this section.

(v) Under the terms of the compensation package that H negotiated with Corp P, Corp P agreed to reimburse H for the expenses that H incurred in maintaining and operating an automobile, including gas and parking, which H purchased in Country V. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(3) of this section, H's compensation with respect to the reimbursement for the expenses H incurred is sourced under paragraphs (b)(2)(ii)(B) and (D)(3) of this section based on H's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in H's gross income as income from sources without the United States.

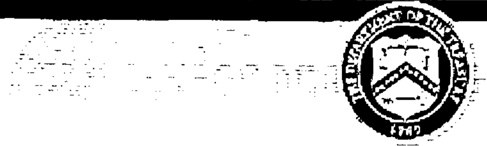
Example 6. (i) On January 1, 2006, Company Q compensates employee J with a grant of options to which section 421 does not apply that do not have a readily ascertainable fair market value when granted. The stock options permit J to purchase 100 shares of Company Q stock for $5 per share. The stock options do not become exercisable unless and until J performs services for Company Q (or a related company) for 5 years. J works for Company Q for the 5 years required by the stock option grant. In years 2006-08, J performs all of his services for Company Q within the United States. In 2009, J performs ½ of his services for Company Q within the United States and ½ of his services for Company Q without the United States. In year 2010, J performs his services entirely without the United States. On December 31, 2012, J exercises the options when the stock is worth $10 per share. J recognizes $500 in taxable compensation (($10-$5) X 100) in 2012.

(ii) Under the facts and circumstances, the applicable period is the 5-year period between the date of grant (January 1, 2006) and the date the stock options become exercisable (December 31, 2010). On the date the stock options become exercisable, J performs all services necessary to obtain the compensation from Company Q. Accordingly, the services performed after the date the stock options become exercisable are not taken into account in sourcing the compensation from the stock options. Therefore, pursuant to paragraph (b)(2)(ii)(A), since J performs 3½ years of services for Company Q within the United States and 1½ years of services for Company Q without the United States during the 5-year period, 7/10 of the $500 of compensation (or $350) recognized in 2012 is income from sources within the United States and the remaining 3/10 of the compensation (or $150) is income from sources without the United States.

*****

(d) Effective date. *** The first sentence of §1.861-4(a)(1) and §1.861-4(b) apply to taxable years beginning on or after publication of the Treasury Decision adopting these rules as final regulations in the **Federal Register**.

Deputy Commissioner for Services and Enforcement.
Mark E. Matthews



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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July 27, 2004
JS-1840

Treasury and IRS Issue Regulations on the Foreign Tax Credit Treatment of Charitable Contributions

Today Treasury and the IRS issued temporary and proposed regulations regarding the treatment of charitable deductions for foreign tax credit purposes. The new rules adopt a simpler and more favorable method of allocating and apportioning charitable deductions than the methods in current regulations or in regulations that were proposed in 1991. Generally, the new rules provide that a contribution that is deductible pursuant to the Internal Revenue Code is allocated and apportioned solely to U.S.-source income for foreign tax credit purposes.

"These new regulations provide clear rules for the treatment of charitable contributions," said Greg Jenner, Acting Assistant Secretary for Tax Policy. "By adopting the straightforward approach of allocating contributions that are deductible for U.S. tax purposes to U.S.-source income, the regulations ensure that the incentives for charitable contributions work as intended."

A taxpayer generally may deduct a contribution made to a charitable organization provided that the contribution is to be used in the United States or one of its possessions for specified purposes. Current regulations provide that, for foreign tax credit purposes, deductions for charitable contributions allowed under the Internal Revenue Code generally are ratably apportioned to U.S.- and foreign-source income on the basis of gross income. In 1991, regulations were proposed that would have changed this ratable apportionment rule to a rule that generally would apportion the deduction for a charitable contribution based on where the contribution would be used. The proposed and temporary regulations issued today would replace both the existing regulations and the regulations proposed in 1991. The temporary regulations are effective for charitable contributions made on or after July 28, 2004, and taxpayers may elect to apply the temporary regulations to all charitable contributions made during a taxable year ending on or after July 28, 2004.

REPORTS

- Temporary
- Proposed Regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9143]

RIN 1545-AP30

Allocation and Apportionment of Deductions for Charitable Contributions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary regulations relating to the allocation and apportionment of the deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B). These regulations change the method of allocating and apportioning these deductions from ratable apportionment on the basis of gross income to apportionment on the basis of income from sources within the United States. The temporary regulations will affect individuals and corporations that make contributions to charitable organizations and that have foreign source income and calculate their foreign tax credit limitations under section 904. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the **Federal Register**. This document also contains final regulations that remove the existing regulations concerning allocation and apportionment of charitable contribution deductions.

DATES: Effective Date: These regulations are effective on July 28, 2004.

Applicability Dates: For dates of applicability, see §§1.861-8(a)(5), 1.861-

8T(e)(12)(iv), and 1.861-14T(e)(6)(ii). The regulations are applicable to charitable contributions made on or after July 28, 2004. Taxpayers may elect to apply these regulations to contributions made before July 28, 2004, but during a taxable year ending after July 28, 2004.

FOR FURTHER INFORMATION CONTACT: Teresa Burridge Hughes (202) 622-3850 (not a toll free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the regulations under section 861 relating to the allocation and apportionment of the deduction for charitable contributions allowed under sections 170, 873(b)(2), and 882(c). Currently, regulations under §1.861-8(e)(9)(iv) provide that such deductions generally are not definitely related to any gross income and therefore are ratably apportioned to the statutory and residual groupings on the basis of gross income.

In 1991, the Treasury Department and the IRS issued proposed regulations (the 1991 proposed regulations) that would have changed the ratable apportionment rule of the final regulations to a rule that, assuming certain requirements are met, generally would apportion the deduction for a charitable contribution based on where the contribution would be used. Prop. Treas. Reg. §1.861-8(e)(12), 56 Fed. Reg. 10,395 (1991). More specifically, the 1991 proposed regulations provided that the deduction for a charitable contribution would have been apportioned solely to foreign source gross income if the taxpayer, at the time of the contribution, knows or has reason to know that the contribution will be used solely outside the United States or

that the contribution may necessarily be used only outside the United States. The 1991 proposed regulations also provided that the deduction for a charitable contribution would have been apportioned solely to U.S. source gross income if the taxpayer, at the time of the contribution, both designates the contribution for use solely in the United States and reasonably believes that the contribution will be so used. Under the 1991 proposed regulations, a deduction for a charitable contribution that is not apportionable to United States or foreign source gross income under the foregoing rules would have been ratably apportioned on the basis of gross income.

The preamble to the 1991 proposed regulations requested comments on the effects of the proposed rules on U.S. charities with significant international activities. Numerous comments were received on the 1991 proposed regulations, most of which recommended that the proposed rules not be adopted. The principal reason given was that the 1991 proposed regulations would reduce funding for foreign charitable activities generally. In addition, the designation and place of use requirements were seen as generating significant paperwork and accountability burdens for both the contributors and the recipient charities. Many comments suggested that, instead of the bifurcated allocation and apportionment in the proposed regulations, the deduction for a charitable contribution should be allocated solely to income from sources within the United States.

In response to the comments received, and upon further consideration of the issue, the 1991 proposed regulations are being withdrawn. See Notice of Proposed Rulemaking published in the Proposed Rules section of this issue of the **Federal**

Register. In addition, the notice of proposed rulemaking includes proposed regulations which cross reference these temporary regulations and proposed regulations with respect to deductions for charitable contributions that are allowed under a U.S. income tax treaty (rather than under sections 170, 873(b)(2), and 882(c)(1)(B)).

Explanation of Provisions

The temporary regulations provide that the deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B) is definitely related and allocable to all of the taxpayer's gross income and is apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources in the United States in each grouping. For example, where a deduction for charitable contributions is allocated and apportioned for purposes of the foreign tax credit limitation, the charitable contribution deduction is allocated to all of the taxpayer's gross income and apportioned solely to the residual grouping consisting of U.S. source gross income. This revision of the regulations is consistent with the policy of the section 170 contribution rules. The revision is intended to ensure that a taxpayer is not discouraged from making a charitable contribution that is deductible under section 170 simply because the allocation and apportionment rules would reduce the taxpayer's foreign source income and, accordingly, the taxpayer's foreign tax credit limitation as a result of the deduction.

The temporary regulations also provide that, where a charitable contribution is made by a member of an affiliated group, the deduction for the charitable

contribution is related to and allocated to the income of all of the members of the affiliated group and not to any subset of the group. This rule is consistent with the provisions of Notice 89-91 (1989-2 C.B. 408). Finally, the provisions of the final regulations under §1.861-8(e)(9)(iv) and §1.861-8(g), Example 18, which provide for ratable allocation and apportionment of deductions for charitable contributions, are removed.

The regulations are effective for charitable contributions made on or after July 28, 2004. Taxpayers may elect to apply these regulations to contributions made before July 28, 2004, but during a taxable year ending on or after July 28, 2004.

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-referenced notice of proposed rulemaking published in the Proposed Rules section in 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 their impact on small businesses.

Drafting Information

The principal author of these regulations is Teresa Burridge Hughes, Office of Associate Chief Counsel (International). 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.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 – INCOME TAXES

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

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

Par. 2. Section §1.861-8 is amended as follows:

1. Remove the language "paragraphs (c)(2)" from paragraph (a)(2) and add the language "paragraphs (c)(3)" in its place.

2. Add a new second sentence to paragraph (a)(5)(i).

3. Revise paragraph (e)(1).

4. Remove the language "paragraph (c)(2)" from the paragraph (e)(9) introductory text and add the language "paragraph (c)(3)" in its place.

5. Add the word "and" at the end of paragraph (e)(9)(iii).

6. Remove paragraphs (e)(9)(iv) and (g) Example 18 (iv).

7. Redesignate paragraph (e)(9)(v) as paragraph (e)(9)(iv).

8. Add new paragraph (e)(12).

9. Redesignate paragraph (g) Example 18 (i) as paragraph (g) Example 18 (i)(A).

10. Remove the last three entries in the table following the language "Total gross income ....40,000,000" from newly designated paragraph (g) Example 18 (i)(A).

11. Add new paragraph (g) Example 18 (i)(B) immediately following the table in newly designated paragraph (g) Example 18 (i)(A).

12. Designate the undesignated text following new paragraph (g) Example 18 (i)(B) as paragraph (g) Example 18 (i)(C).

The revisions and additions read as follows:

§1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

(a) * * * (1) * * *

(5) * * * (i) * * *Paragraph (g) Example 18 (i)(B) applies to charitable contributions made on or after July 28, 2004. * * *

* * * * *

(e) Allocation and apportionment of certain deductions--(1) In general. Paragraphs (e)(2) and (e)(3) of this section contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Paragraphs (e)(4) through (e)(8) of this section contain rules with respect to the allocation of certain other deductions. Paragraph (e)(9) of this section lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Paragraph (e)(10) of this section lists special deductions of corporations which must be allocated and apportioned. Paragraph (e)(11) of this section lists personal exemptions which are neither

allocated nor apportioned. Paragraph (e)(12) of this section contains rules with respect to the allocation and apportionment of deductions for charitable contributions. Examples of allocation and apportionment are contained in paragraph (g) of this section.

* * * * *

(12) [Reserved]. For further guidance, see §1.861-8T(e)(12).

* * * * *

(g) General examples. * * *

Example 18. * * * (i)(A) * * *

(i)(B) In addition, X incurs expenses of its supervision department of $1,600,000.

* * * * *

Par. 3. Section 1.861-8T is amended as follows:

1. Add new paragraph (e)(12).

2. Add a new second sentence to paragraph (h).

The additions read as follows:

§1.861-8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

* * * * *

(e) * * * (1) * * *

(12) Deductions for certain charitable contributions--(i) In general. The deduction for charitable contributions that is allowed under sections 170, 873(b)(2), and 882(c)(1)(B) is definitely related and allocable to all of the taxpayer's gross

income. The deduction allocated under this paragraph (e)(12)(i) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources in the United States in each grouping.

(ii) Coordination with §1.861-14T. A deduction for a charitable contribution by a member of an affiliated group shall be allocated and apportioned under the rules of this section and §1.861-14T(c)(1).

(iii) Treaty provisions. [Reserved]

(iv) Effective date. (A) The rules of paragraphs (e)(12)(i) and (ii) shall apply to charitable contributions made on or after July 28, 2004. Taxpayers may apply the provisions of paragraphs (e)(12)(i) and (ii) to charitable contributions made before July 28, 2004, but during the taxable year ending on or after July 28, 2004.

(B) The applicability of this section expires on or before July 27, 2007.

* * * * *

(h) * * * However, see paragraph (e)(12)(iv) of this section and §1.861-14T(e)(6)(ii) for rules concerning the allocation and apportionment of deductions for charitable contributions. * * *

* * * * *

Par. 4. Section 1.861-14T is amended by revising the section heading and adding paragraph (e)(6) to read as follows:

§1.861-14T Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations (temporary).

* * * * *

(e) * * * (1) * * * (i) * * *

(6) Charitable contribution expenses--(i) In general. A deduction for a charitable contribution by a member of an affiliated group shall be allocated and apportioned under the rules of §1.861-8T(e)(12) and paragraph (c)(1) of this section.

(ii) Effective date. (A) The rules of this paragraph shall apply to charitable contributions made on or after July 28, 2004, and, for taxpayers applying the second sentence of §1.861-8T(e)(12)(iv)(A), to charitable contributions made during the taxable year ending on or after July 28, 2004.

(B) The applicability of this section expires on or before July 27, 2007.

* * * * *

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement

Approved: July 20, 2004

/s/ Gregory Jenner

Acting Assistant Secretary of the Treasury

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-208246-90]

RIN 1545-BD47

Allocation and Apportionment of Deductions for Charitable Contributions

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document withdraws the notice of proposed rulemaking published on March 12, 1991 (the 1991 proposed regulations), relating to the allocation and apportionment of charitable deductions. In addition, in the Rules and Regulations section of this issue of the **Federal Register**, the Treasury Department and the IRS are issuing temporary regulations providing that the deduction for a charitable contribution (as defined in section 170(c)) is to be allocated to all of the taxpayer's gross income and apportioned on the basis of income from sources within the United States. The text of the temporary regulations also serves as the text of these proposed regulations. Further, regulations are proposed in this document, without cross-reference to temporary regulations, with respect to deductions for charitable contributions that are provided by an income tax treaty rather than by sections 170, 873(b)(2), and

882(c)(1)(B). This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by October 26, 2004. Outlines of topics to be discussed at the public hearing scheduled for December 2, 2004, at 10 a.m. must be received by November 12, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-208246-90), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-208246-90), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW., Washington, DC or sent electronically, via the IRS internet site at www.irs.gov/regs or Federal eRulemaking Portal at www.regulations.gov (IRS and REG-208246-90). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Ave., NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the withdrawal of the 1991 proposed regulations and the proposed regulations, Teresa Burridge Hughes, (202) 622-3850 (not a toll-free number); concerning the submission of comments, the hearing, and/or placement on the building access list to attend the hearing, Treena Garrett, (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Section 1.861-8(e)(9) provides that the deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B) is generally considered as not definitely related to any gross income and therefore is ratably apportioned to all of a taxpayer's gross income. On March 12, 1991, Treasury and the IRS published in the **Federal Register** (56 FR 10395) a notice of proposed rulemaking (INTL-116-90, REG-208246-90) that would have modified the allocation and apportionment of the deduction for charitable contributions. The 1991 proposed regulations generally would have provided for the allocation and apportionment of a deduction for a charitable contribution to sources within or without the United States based on where the contribution was used. Where the deduction for a charitable contribution would not have been allocable to United States or foreign source gross income based on the new test, it would have been ratably apportioned to all gross income. Written comments were received and a public hearing on the 1991 proposed regulations was held on August 1, 1991. In response to comments received, and after further consideration of the issue, the 1991 proposed regulations are withdrawn.

Contemporaneously with the withdrawal of the 1991 proposed regulations, the Treasury Department and the IRS are issuing a Treasury decision containing temporary regulations that are published in the Rules and Regulations section in this issue of the **Federal Register**. The temporary regulations provide for the allocation and apportionment of the deduction for charitable contributions to U.S.

source income. The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations discusses the comments received on the 1991 proposed regulations, the reasons for the withdrawal of the 1991 proposed regulations, and the approach of the temporary regulations.

This document also proposes a rule for the allocation and apportionment of deductions for charitable contributions that are allowed under a U.S. income tax treaty (rather than under sections 170, 873(b)(2), and 882(c)(1)(B)) that limits the amount of the deduction based on a percentage of income that arises from sources within the treaty partner. In such case, these proposed regulations would provide that the deduction is definitely related and allocable to all of the taxpayer's gross income. The deduction would be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources within the treaty partner within each grouping This rule is proposed to be effective for taxable years beginning on or after the date 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 also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of

information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the 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 their impact on small businesses.

Comments and Public Hearing

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

A public hearing has been scheduled for December 2, 2004, beginning at 10 a.m. in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For more information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

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

comments by October 26, 2004, and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 12, 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 this document is Teresa Burridge Hughes, Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in its development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of a Notice of Proposed Rulemaking

Under the authority of 26 U.S.C. 7805, §1.861-8(e) and (g) of the notice of proposed rulemaking (INTL-116-90) published in the **Federal Register** on March 12, 1991, (56 FR 10395) is withdrawn.

Proposed Amendments to the Regulations

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

PART 1 – INCOME TAXES

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

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

Par. 2. Section 1.861-8(e)(12) is added to read as follows:

§1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * * (1) * * *

(e)(12)(i) and (ii) [The text of the proposed addition of §1.861-8(e)(12)(i) and (ii) is the same as §1.861-8T(e)(12)(i) and (ii) published elsewhere in this issue of the **Federal Register**.]

(e)(12)(iii) Treaty provisions. (A) In general. If a deduction for charitable contributions not otherwise permitted by sections 170, 873(b)(2), and 882(c)(1)(B) is allowed under a U.S. income tax treaty, and such treaty limits the amount of the deduction based on a percentage of income arising from sources within the treaty partner, the deduction is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(iii) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources within the treaty partner within each grouping.

(B) The rules of this paragraph (e)(12)(iii) are applicable for charitable contributions made on or after the date of publication of this document as a final regulation in the **Federal Register**.

(e)(12)(iv)(A) [The text of the proposed addition of §1.861-8(e)(12)(iv)(A) is the same as §1.861-8T(e)(12)(iv)(A) published elsewhere in this issue of the **Federal Register**.]

(e)(12)(iv)(B) [Reserved].

Par. 4. Section 1.861-14(e)(6) is revised to read as follows:

§1.861-14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.

* * * * *

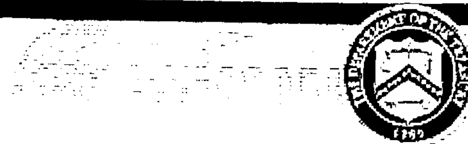
(e) * * * (1) * * *

(e)(6) [The text of the proposed revision of §1.861-14(e)(6) is the same as §1.861-14T(e)(6) through (e)(6)(ii)(A) published elsewhere in this issue of the **Federal Register**.]

* * * * *

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 2, 2004
JS-1841

U.S. Department of Treasury Statement
Concerning the Extractive Industries Review

The Treasury Department has examined the final report of the Extractive Industries Review commissioned by World Bank President Wolfensohn as well as the World Bank Management's response to that report. The Department has also reviewed internal World Bank evaluations related to the subject and the World Bank Management's responses to them. Overall, we believe that if the actions laid out in the Management responses are implemented, the World Bank Group would be headed in the right direction with respect to its future role in extractive industries. The responses rightly recognize that, when properly managed, extractive industries offer important benefits in terms of providing the energy services and materials needed to grow a modern economy, as well as a stream of revenues to governments for public services and poverty reduction. At the same time, the responses acknowledge that extractive industries can pose environmental, social, and governance risks and that the World Bank Group needs to play a more effective role in the mitigation of those risks in client countries.

The Department agrees that the Bank should stay engaged with financing oil and coal projects as long as this engagement is on a highly selective basis, that is, where the Bank's "additionality" is adequate. Based on the same test we also support lending for developing natural gas resources as both a bridging fuel and for economic development. When financing an extractive industries project, the World Bank Group should ensure establishment of an appropriate revenue management mechanism, commit adequate internal resources for monitoring its operation, and take appropriate (and timely) actions if the mechanism is not being fully implemented.

The US has been a strong advocate for greater fiscal accountability and transparency, including through G8 declarations at Evian and Sea Island. The Extractive Industries Review points to the need for increased transparency of revenue flows from extractive industries operations to governments. In fact, we believe financial assistance should be predicated upon the government of a country where a project is located having in place, or committing to establish, a functioning system for accounting for revenues and expenditures. The government should also have in place, or commit to establish, a functioning system for the independent auditing of such accounts and the public dissemination of the results. Furthermore, we would like there to be an ex ante presumption of disclosure of such documents as Host Government Agreements, Concession Agreements, and bidding documents, allowing for redaction of, or exceptions for, commercially proprietary information.

We agree that there exist high value biodiversity resources both inside and outside of formally designated protected areas and that some such areas may not be appropriate for new extractive industries investments. We believe the International Finance Corporation should engage with international experts and stakeholders to develop and implement appropriate criteria and decision processes that will be consistently and transparently applied to determine whether or not to finance an extractive project in areas of high biodiversity, high species endemism or areas providing key ecosystem services. This process should include consideration of the status of land use planning in the host country (including its existing and proposed system of protected areas), implementation of relevant national laws and international conventions, and current scientific understanding of the risks to biodiversity and ecosystem services associated with the extractive project.

We support targets for increased lending for both renewable energy and energy

efficiency as long as: 1) they not distort financial sustainability, and 2) financed projects result in improved access and affordability of energy services. Moreover, targets focused on financial inputs should be supplemented by targets that focus on outcomes. We are less interested in the amount of money allocated to stand-alone renewable energy and efficiency projects than in more systematically mainstreaming these technologies into different lending sectors.

We also recognize that market and policy failures may affect energy choices. For example, economic losses due to pollution from different energy sources may not be factored into the decision process for energy investments. In this regard, we encourage efforts to address institutional and policy distortions in developing countries that may inappropriately skew decision-making by energy producers or consumers.

We support the principle that local communities should benefit from projects that affect them. We believe that *ex ante* screening of extractive industries projects should be adopted, and that such screening evaluate the acceptance of, and impact on, locally affected communities

As long as it is carefully managed, we also support the establishment of a multi-stakeholder consultation mechanism to continue the dialogue on issues in which a sharp divergence of views remains, tap into expertise on a range of technical issues, and explore voluntary initiatives that require participation of outside stakeholders (particularly those in host countries). For example this mechanism could be used to: (1) design and pilot test new approaches, such as for upstream engagement of affected communities; (2) explore collaborative initiatives to identify best social and environmental practices on specific activities; and/or (3) advance efforts to implement minimum criteria for transparency of public finances as a tool for helping to ensure that the use of natural resources contributes to shared development progress.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 5, 2004
JS-1842

The Honorable John W. Snow
Remarks as Prepared for Delivery Following the Tour of Infocision
Akron, OH

I'm delighted to be home in Ohio today, and to be visiting Infocision. The employees here are doing great work, and I applaud the management of Infocision for their terrific relationship with the local community, particularly their partnership with the Akron Community and Technical College.

The folks here at Infocision understand that Community Colleges are a critical partner to the business community when it comes to finding skilled employees. And Community Colleges tend to understand that workers need training that matches up with actual jobs in their home town.

The more we can match up workers with good skills, and skilled workers with good jobs and employers who need them, the more American families will move forward, economically.

When community colleges and job-creators work together, people find good work more quickly and businesses get the skilled employees they need. This is particularly important in more rural areas where the variety of job opportunities is more limited. A worker really needs to have the skills needed in his or her geographic area, and most Americans are within driving distance of a community college.

That's why the President is dedicated to promoting and helping our community colleges, and making them a more integral part of our nation's workforce investment system.

Because nothing is more important here in Ohio than getting people back to work, and nothing is more important to families all over the country.

I know that bad economic times hit Ohio hard. And the effort to get your economy on solid footing, to a place where you can expand, grow and create more jobs, is ongoing.

I am pleased to report that our national economy has found that footing, and it is expanding and creating jobs. Small businesses are hiring, and they are optimistic. Consumer optimism is high, too... and these are both indicators that bode very well for continued economic growth and job creation.

But this is little comfort to Ohioans who lost a job during the economic downturn. Comfort can only come when a new job is found. Nearly 18,000 jobs have been added in Ohio so far this year, but that's not enough. Making sure that more jobs are created has therefore been the top domestic priority of President Bush's administration.

Job growth was the goal of the tax cuts. The tax relief paid particular attention to small businesses – America's job-creators. Coupled with sound monetary policy and an unwavering commitment to free, open trade have helped create an environment nationwide in which new jobs could be produced.

Here in Ohio, more than 4.4 million taxpayers will have lower income tax bills in 2004 thanks to the President's tax cuts. Nearly 860,000 Ohio business taxpayers

will be able to use their tax savings to invest in their employees' pay or benefits, the purchase of new equipment, or hiring of new staff.

Raising your taxes right now would be terrible news for our economy, and for every Ohioan who seeks work.

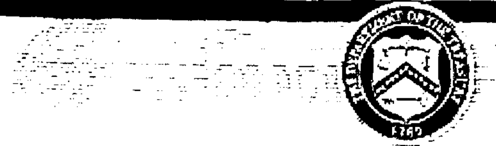
We need to keep the burden as light as we can on small businesses and individuals if we want to encourage the creativity and innovation that leads to job creation.

I am optimistic that times will get better in Ohio. You will not be left behind; the U.S. economy is too strong for that. We're going to keep growing as a country, and Ohioans will be part of that growth.

The most powerful elements of our economy are our small-business owners and entrepreneurs, our outstanding workforce and the simple fact that we operate as a free market. We are fortunate that our economy is more open, flexible, adaptive and resilient than any other in the world. And as long as we continue on the path of freedom, making sure that individuals and entrepreneurs have an environment in which they can work and grow, our best days will remain ahead of us, all across this great country.

Thank you so much for having me here today.

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

August 5, 2004
js-1843

Treasury Announces Opening of Third Round of Competition For New Markets Tax Credit Program

$2 Billion in New Markets Tax Credits Available

The U.S. Department of the Treasury announced today the opening of the third round of competition for the allocation of up to $2 billion in tax credits under the New Markets Tax Credit (NMTC) Program.

"The NMTC Program supports the President's agenda of promoting investments that will lead to economic growth and job creation," said Treasury Secretary John W. Snow. "I have witnessed first hand the NMTC Program's potential to stimulate private sector investment in many of our nation's low-income communities. From a daycare center in Chicago to a commercial and cultural center in San Diego to a sustainable forestry timber mill in northern Maine, the NMTC Program is helping to foster economic growth and create needed jobs throughout the country."

Created by Congress in December 2000, the NMTC Program permits individual and corporate taxpayers to receive a credit against Federal income taxes for making Qualified Equity Investments in investment vehicles known as Community Development Entities or CDEs. Substantially all of the investment must in turn be used by CDEs to make qualified investments in low-income communities. The credit provided to the taxpayer totals 39 percent of the cost of the investment and is claimed over a seven-year credit allowance period.

Through the first two program rounds, the Treasury Department's Community Development Financial Institutions (CDFI) Fund has made 129 NMTC awards, totaling $6 billion in tax credit allocation authority. "The level of interest in this program has been overwhelming," said CDFI Fund Director Arthur Garcia. "To date, we have received strong, widespread interest in the allocation authority the Fund is prepared to issue. Clearly, NMTCs are viewed as a critical tool for promoting economic development in low-income communities."

Successful CDEs will be allocated NMTC awards after a competitive application and review process administered by the CDFI Fund. Guidance on the third round of the NMTC Program is currently available on the CDFI Fund's website at www.cdfifund.gov. The allocation application deadline is October 6, 2004.

The CDFI Fund is offering a free interactive video teleconference on Tuesday, August 24, 2004 at 1:00 p.m. EDT. The teleconference will be broadcast from Washington, D.C. and down-linked via satellite to over 80 locations nation-wide. To learn more about this training or to register, please visit the CDFI Fund's website.

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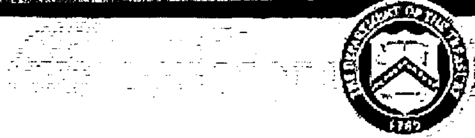


PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 6, 2004
JS-1844

The Honorable John W. Snow
Prepared Remarks
The Pittsburgh Technology Council
August 6, 2004
8:00am

It's great to be here in Pittsburgh today, and I'm honored to have the chance to visit with you: the business leaders of this fine city.

Many of you are small-business owners. You're all entrepreneurs. And that puts you at the very center of the American economy. Entrepreneurship thrives here like nowhere else in the world. Our workforce is the best in the world as well, and as a result our economy is the most dynamic and innovative. I believe we owe all of this to the simple fact that we embrace the idea of a free market economy so fully.

The economic recovery and expansion that this country is experiencing today is largely thanks to the hard work of you and your employees. You are the embodiment of the free enterprise system.

I appreciate what you do to keep this economy strong, to create good jobs for the hardworking people of Pennsylvania, and produce products and services that improve the lives of your customers. Our economy has been through some massive shocks over the last four years, starting with the recession which President Bush inherited. He responded with a bold tax proposal to get the economy moving and give it a needed boost. I hope that the President's tax cuts gave you the oxygen you needed after our economy and our country endured some very harsh blows.

The President's tax cuts were designed with you in mind, because he understands that small and independent businesses are the lifeblood of the American economy. He understands that the smallest businesses create three out of every four net new jobs. He understands that job growth happens one small business at a time... but that can add up to millions of jobs across the country.

So he made sure that small employers like many of you in this room today would be able to keep more of your earnings, and reinvest them in your business.

He made sure it was easier for you to invest in new business equipment to help your companies grow.

And he is still fighting to make elimination of the death tax permanent... so you and your family can plan for the future of the business without fear of that punishing tax.

We want to make sure that the tax relief lasts, too, so you can continue to grow your business without the extra weight. Because we still need more jobs – there are still Pennsylvanians and workers throughout America who seek work. We want new jobs for all those who seek them and a growing, expanding economy is the surest path to those new jobs.

In 2004, more than 4.6 million Pennsylvania taxpayers will have lower income tax bills thanks to the President's tax cuts. More than 910,000 business taxpayers here will be able to use their tax savings to grow their companies, create jobs and increase employee compensation.

So far, tax cuts have helped this state by lightening the burden on its individual and

business taxpayers. Since February of this year, nearly 70,000 new jobs have been created here in Pennsylvania by businesses like yours. And that's the best news possible for tens of thousands of Pennsylvania families.

Initiatives like the New Markets Tax Credit (NMTC) program also help with economic growth and job creation in areas that are most in need. That's why I was pleased to announce yesterday the opening of the third round of competition for the allocation of up to $2 billion in tax credits under the program. I have witnessed first hand the NMTC Program's potential to stimulate private sector investment in many of our nation's low-income communities. From a daycare center in Chicago to a commercial and cultural center in San Diego to a sustainable forestry timber mill in northern Maine, the NMTC Program is helping to foster economic growth and create needed jobs throughout the country."

Is our economy getting better? Is it growing and expanding and creating good jobs? Absolutely. We are growing, jobs are being created all over the country, after-tax incomes are up and homeownership is at an all-time high. All that means that families are doing better and are more able to afford the things they need, from dishwashers to new cars to children's shoes.

But can we do better? Of course we can, and we will. As long as we continue on the path of freedom, making sure that individuals and entrepreneurs have an environment in which they can work and grow, our best days will remain ahead of us, all across this great country.

Thank you again for all you do for the people of Pittsburgh, and thank you so much for having me here today.

Bureau of the
PublicDebt
United States Department of the Treasury

'ublic Debt Announces Activity for Securities in the STRIPS Program for July :004

OR RELEASE AT 3:00 PM

ugust 5, 2004

ıe Bureau of the Public Debt announced activity for the month of July 2004, of securities within the Separate Trading of Registered ıterest and Principal of Securities program (STRIPS).

	In Thousands
'rincipal Outstanding (Eligible Securities)	$ 2,745,432,576
łeld in Unstripped Form	$ 2,567,259,333
łeld in Stripped Form	$ 178,173,242
ˀeconstituted in July	$ 13,679,353

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

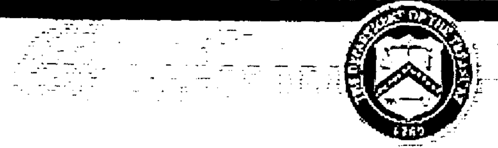
ıe STRIPS table, along with the new Monthly Statement of the Public Debt, is available on Public Debt's Internet site at: ww.publicdebt.treas.gov. A wide range of information about the public debt and Treasury securities is also available at the site.

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 1845



PRESS ROOM

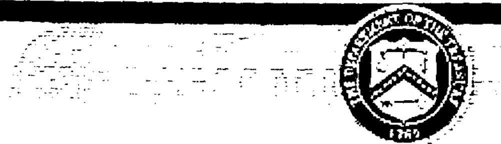
FROM THE OFFICE OF PUBLIC AFFAIRS

August 6, 2004
JS-1846

Statement of Secretary John W. Snow
on July Employment Report

Today's employment report shows that the economy continues to move in the right direction. The unemployment rate declined in July to 5.5 percent and we added jobs for the eleventh straight month. The manufacturing sector continues to improve, adding 10,000 jobs in July. With the addition of 91,000 jobs since February, the manufacturing sector has had its best six-month period in six years.

The report is a sign that the American economy is continuing on a path of growth and expansion, and that the President's tax relief continues to givemomentum to that upward path. While this ongoing economic progress is encouraging, we're not satisfied and there is more for us to do. The President's pro-growth policies will keep us on the right track and help us to unleash the full potential of America's economy.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 6, 2004
JS-1847

MEDIA ADVISORY
Treasury Official to Lead Financial Education Roundtable in Orlando

Assistant Secretary for Financial Institutions, Wayne Abernathy will lead a financial education roundtable at the InCharge Education Foundation in Orlando, Florida. Abernathy will discuss Treasury's financial education initiatives, the role of the new Financial Literacy and Education Commission and how local organizations can contribute to the overall mission of improving financial education. Orlando business, nonprofit, academic and local government representatives will also participate in the forum.

The InCharge Education Foundation is a national non-profit organization specializing in personal finance education and research. The organization promotes financial education through its various programs.

WHO:
Assistant Secretary for Financial Institutions Wayne Abernathy

WHAT:
Financial Education Roundtable

WHEN:
Tuesday, August 10, 2004
12 p.m. EST

WHERE:
InCharge Education Foundation
2101 Park Center Drive
3rd Floor, Gallery Conference Roon
Orlando, FL 32835

Media interested in covering this event should call Treasury's Office of Public Affairs at (202)622-2960.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 6, 2004
JS-1848

Treasury Answers Schedule M-3 Questions

On July 7, 2004, The Treasury Department and the Internal Revenue Service issued Rev. Proc. 2004-45, which streamlines the disclosure by taxpayers of transactions with a significant book-tax difference. Section 4.01 of Rev. Proc. 2004-45 eliminates the overlap between the revised return disclosure regulations finalized in February 2003 and the new Schedule M-3. Sections 4.02 and 4.03 of Rev. Proc. 2004-45 also provide procedures ("alternative disclosure procedures") that simplify the disclosure of book-tax differences for 2003 and for businesses that are not required to complete the new Schedule M-3.

Taxpayers and practitioners have raised several questions regarding the alternative disclosure procedures. The Treasury Department and the IRS may issue guidance, having the same effective date as Rev. Proc. 2004-45, to address these questions and clarify aspects of Rev. Proc. 2004-45. In the interim, the following questions and answers are provided:

1. ***Do the alternative disclosure procedures apply only to corporations?*** No. The alternative disclosure procedures apply to corporations and other business entities, including, for example, partnerships and S corporations.
2. ***Can taxpayers use the alternative disclosure procedures for the 2003 taxable year?*** Yes. Taxpayers may use the alternative disclosure procedures for taxable years ending before December 31, 2004.
3. ***If a taxpayer uses the alternative disclosure procedures, must the taxpayer complete all parts of Schedule M-3?*** No. The taxpayer is only required to complete Columns B and C of Parts II and III of Schedule M-3 for any difference greater than $10 million.
4. ***If a taxpayer uses the alternative disclosure procedures, must differences of $10 million or less be disclosed on Schedule M-3?*** No. Only differences greater than $10 million must be disclosed.
5. ***Under the alternative disclosure procedures, how must a taxpayer determine whether a difference is greater than $10 million?*** The determination is made on an item-by-item basis (for each member, in the case of a U.S. consolidated tax group) in accordance with the rules applicable to a corporation required to complete Schedule M-3, and not on a transaction-specific basis (notwithstanding § 1.6011-4(b)(6)).
6. ***Under the alternative disclosure procedures, may a taxpayer disclose differences greater than $10 million on a substitute schedule (e.g., a spreadsheet) in lieu of Schedule M-3?*** No. Differences greater than $10 million must be disclosed on the most recent version of Schedule M-3 (see attachment below).
7. ***Under the alternative disclosure procedures, must a taxpayer disclose differences that do not affect financial statement or taxable income?*** No. Only differences greater than $10 million that affect financial statement or taxable income must be disclosed. Other differences that do not affect financial statement or taxable income, such as differences in computing earnings and profits, are not required to be disclosed.
8. ***If a U.S. consolidated tax group uses the alternative disclosure procedures, must all members of the group comply with the procedures?*** Yes. The alternative disclosure procedures must be applied consistently by all members of the group.
9. ***Must a U.S. consolidated tax group using the alternative disclosure procedures take into account intercompany transactions?*** No. A U.S. consolidated tax group has the option of determining whether a difference is greater than $10 million by including or excluding intercompany

transactions. However, all members of a U.S consolidated tax group must make the determination in the same manner, i.e., all members must either include or exclude intercompany transactions. If a U.S. consolidated tax group excludes intercompany transactions, excluded intercompany transactions greater than $10 million are not required to be disclosed on a Schedule M-3.

10. ***Is a taxpayer using the alternative disclosure procedures required to disclose differences described in Rev. Proc. 2003-25?*** No. If a taxpayer uses the alternative disclosure procedures and has a difference greater than $10 million that is described in Rev. Proc. 2003-25, the taxpayer may exclude the disclosure of that difference on Schedule M-3.
11. ***Do the alternative disclosure procedures satisfy a taxpayer's disclosure obligations for other reportable transactions?*** No. The alternative disclosure procedures are limited to transactions described in § 1.6011-4(b)(6) (transactions with a significant book-tax difference) and do not satisfy a taxpayer's disclosure obligation with respect to a transaction described in §§ 1.6011-4(b)(2) (listed transactions), (b)(3) (confidential transactions), (b)(4) (transactions with contractual protection), (b)(5) (loss transactions), or (b)(7) (transactions with a brief asset holding period), even if the transaction is also described under § 1.6011-4(b)(6). For example, if a taxpayer uses the alternative disclosure procedures and engages in a transaction described in § 1.6011-4(b)(3) that results in a difference greater than $10 million, the taxpayer must, nevertheless, disclose the difference on Schedule M-3 and also must disclose the transaction as a confidential transaction on Form 8886, Reportable Transaction Disclosure Statement.

-30-

REPORTS

- Schedule M-3 released July 7, 2004
- Rev. Proc. 2004-45

SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More

▶ Attach to Form 1120.
▶ See separate instructions.

OMB No. 1545-0123

2004

Name | **Employer identification number**

Part I **Financial Information and Net Income (Loss) Reconciliation**

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
☐ **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
☐ **No.** Go to line 1b.

b Did the corporation prepare a certified audited income statement for that period?
☐ **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
☐ **No.** Go to line 1c.

c Did the corporation prepare an income statement for that period?
☐ **Yes.** Complete lines 2a through 11 with respect to that income statement.
☐ **No.** Skip lines 2a through 10 and enter the corporation's net income (loss) per its books and records on line 11.

2a Enter the income statement period: Beginning ____/____/____ Ending ____/____/____

b Has the corporation's income statement been restated for the income statement period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**

c Has the corporation's income statement been restated for any of the five income statement periods preceeding the period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☐ **No.**

3a Is any of the corporation's voting common stock publicly traded?
☐ **Yes.**
☐ **No.** If "No," go to line 4.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock . . . ☐☐☐☐☐

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock: . . . ☐☐☐☐☐☐☐☐☐

4	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4	
5a	Net income from nonincludible foreign entities (attach schedule) . . .	5a	( )
b	Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount) . .	5b	
6a	Net income from nonincludible U.S. entities (attach schedule) . . .	6a	( )
b	Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount) . . .	6b	
7a	Net income of other includible entities (attach schedule) . . .	7a	
b	Net loss of other includible entities (attach schedule and enter as a negative amount) . . .	7b	
8	Adjustment to eliminate transactions between includible and nonincludible entities (attach schedule)	8	
9	Adjustment to reconcile income statement year to tax year of tax return (attach schedule) . . .	9	
10	Other adjustments to reconcile to amount on line 11 (attach schedule) . . .	10	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10 . . .	11	

Part II Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return

	Income (Loss) Items	(a) Income (Loss) per Income Statement (optional)	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return (optional)
1	Income (loss) from equity method foreign corporations				
2	Gross foreign dividends not previously taxed				
3	Subpart F, QEF, and similar income inclusions				
4	Section 78 gross-up				
5	Gross foreign distributions previously taxed				
6	Income (loss) from equity method U.S. corporations				
7	U.S. dividends not eliminated in tax consolidation				
8	Minority interest for includible corporations				
9	Income (loss) from U.S. partnerships (attach schedule)				
10	Income (loss) from foreign partnerships (attach schedule)				
11	Income (loss) from other pass-through entities (attach schedule)				
12	Items relating to reportable transactions (attach details)				
13	Tax-exempt interest				
14	Total accrual to cash adjustment				
15	Hedging transactions				
16	Mark-to-market income (loss) other than from inventory				
17	Inventory valuation adjustments				
18	Sale versus lease				
19	Section 481(a) adjustments				
20	Unearned/deferred revenue				
21	Income recognition from long-term contracts				
22	Original issue discount and other imputed interest				
23	Income statement gain/loss on disposition of assets other than inventory				
24	Gain/loss reported on Form 4797, line 18				
25	Gross capital gain from includible corporations				
26	Gross capital loss from includible corporations				
27	Other gain/loss on disposition of assets other than inventory				
28	Disallowed capital loss in excess of capital gains				
29	Utilization of capital loss carryforward				
30	Other income (loss) items with differences (attach schedule)				
31	Other income (loss) items with no differences				
32	**Total income (loss) items.** Combine lines 1 through 31				
33	**Total expense/deduction items** (from Part III, line 41)				
34	**Reconciliation totals.** Subtract line 33 from line 32				

Note. Line 34, column (a), must equal the amount on Part I, line 11, and column (d) must equal the amount on Form 1120, page 1, line 28.

Part III **Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items**

	Expense/Deduction Items	(a) Expense per Income Statement (optional)	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return (optional)
1	U.S. current income tax expense				
2	U.S. deferred income tax expense				
3	State and local current income tax expense				
4	State and local deferred income tax expense				
5	Foreign current income tax expense (other than foreign withholding taxes)				
6	Foreign deferred income tax expense				
7	Foreign withholding taxes				
8	Incentive stock options				
9	Nonqualified stock options				
10	Other equity-based compensation				
11	Meals and entertainment				
12	Fines and penalties				
13	Punitive damages				
14	Excess parachute payments				
15	Excess section 162(m) compensation				
16	Pension and profit-sharing				
17	Other post-retirement benefits				
18	Deferred compensation				
19	Charitable contribution of cash and tangible property				
20	Charitable contribution of intangible property				
21	Charitable contribution limitation				
22	Charitable contribution carryforward used				
23	Current year acquisition or reorganization investment banking fees				
24	Current year acquisition or reorganization legal and accounting fees				
25	Current year acquisition/reorganization other costs				
26	Amortization/impairment of goodwill				
27	Amortization of acquisition, reorganization, and start-up costs				
28	Other amortization or impairment write-offs				
29	Abandonment losses				
30	Worthless stock deduction (attach details)				
31	Section 198 environmental remediation costs				
32	Depletion				
33	Depreciation				
34	Bad debt expense				
35	Expense for contingent liabilities (attach details)				
36	Expense for other reserves (attach details)				
37	Corporate owned life insurance premiums				
38	Section 481(a) adjustments				
39	Other expense/deduction items with differences (attach schedule)				
40	Other expense/deduction items with no differences				
41	**Total expense/deduction items.** Combine lines 1 through 40. Enter here and on Part II, line 33				

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Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, § 6011; 1.6011-4.)

Rev. Proc. 2004-45

SECTION 1. PURPOSE

This revenue procedure provides alternative disclosure procedures that are deemed to satisfy a taxpayer's disclosure obligations under § 1.6011-4 of the Income Tax Regulations for transactions with a significant book-tax difference under § 1.6011-4(b)(6). Taxpayers also may continue to follow the disclosure procedures provided in § 1.6011-4 for disclosing transactions described in § 1.6011-4(b)(6).

SECTION 2. BACKGROUND

.01 Section 1.6011-4 requires a taxpayer who participates in a reportable transaction to disclose the transaction in accordance with the procedures provided in § 1.6011-4. Under § 1.6011-4(b), there are six categories of reportable transactions. One category of reportable transactions is a transaction with a significant book-tax difference. A transaction with a significant book-tax difference is defined in § 1.6011-4(b)(6) as a transaction where the amount for tax purposes of any item or items of income, gain, expense, or loss from the transaction differs by more than $10 million on a gross basis from the amount of the item or items for book purposes in

any taxable year. For purposes of § 1.6011-4(b)(6), the amount of an item for book purposes is determined by applying U.S. generally accepted accounting principles for worldwide income.

.02 Section 1.6011-4(b)(6)(ii) provides that the following taxpayers must disclose transactions with a significant book-tax difference: (1) reporting companies under the Securities Exchange Act of 1934 (15 U.S.C. 78a) and related business entities; and (2) business entities that have $250 million or more in gross assets for book purposes at the end of any financial accounting period that ends with or within the entity's taxable year in which the transaction occurs.

.03 On July 7, 2004, the Treasury Department and Internal Revenue Service released a draft of the final version of Schedule M-3, Net Income (Loss) Reconciliation For Corporations With Total Assets of $10 Million or More. In general, for taxable years ending on or after December 31, 2004, any corporation (or U.S. consolidated tax group) required to file Form 1120, U.S. Corporation Income Tax Return, that reports total assets at the end of the corporation's (or U.S. consolidated tax group's) taxable year that equal or exceed $10 million on Schedule L of Form 1120 is required to complete and file Schedule M-3.

SECTION 3. SCOPE

This revenue procedure applies to a taxpayer that is required to disclose reportable transactions under § 1.6011-4 with respect to transactions described in § 1.6011-4(b)(6).

SECTION 4. APPLICATION

.01 Corporation required to complete Schedule M-3 for a taxable year ending on or after December 31, 2004. For a taxable year ending on or after December 31, 2004, a corporation required to file Schedule M-3 that completes and files Schedule M-3 (in accordance with the instructions to the form, including draft instructions until such instructions are finalized) with the corporation's timely-filed original tax return (including extensions) for the taxable year is deemed to satisfy the disclosure requirements of § 1.6011-4 with respect to transactions described in § 1.6011-4(b)(6) for that taxable year.

.02 Taxpayer not required to complete Schedule M-3 for a taxable year ending on or after December 31, 2004. A taxpayer that is required to disclose reportable transactions under § 1.6011-4 with respect to transactions described in § 1.6011-4(b)(6), but is not required to complete Schedule M-3, for a taxable year ending on or after December 31, 2004, will continue to be subject to the disclosure requirements of § 1.6011-4. However, the taxpayer is deemed to satisfy the disclosure requirements of § 1.6011-4 with respect to transactions described in § 1.6011-4(b)(6) for a taxable year ending on or after December 31, 2004, if the taxpayer complies with the alternative disclosure procedures described in section 4.04 of this revenue procedure for that taxable year.

.03 Alternative disclosure procedures for a taxable year ending before December 31, 2004, for transactions entered into on or after January 1, 2003. For a taxable year ending before December 31, 2004, a taxpayer required to disclose

reportable transactions under § 1.6011-4 with respect to transactions described in § 1.6011-4(b)(6) that were entered into on or after February 28, 2003, is deemed to satisfy the disclosure requirements of § 1.6011-4 with respect to those transactions if the taxpayer complies with the alternative disclosure procedures described in section 4.04 of this revenue procedure. These rules also may be relied upon for taxable years ending before December 31, 2004, with respect to transactions entered into on or after January 1, 2003, and before February 28, 2003, that are subject to disclosure under § 1.6011-4 or § 1.6011-4T with respect to transactions described in § 1.6011-4(b)(6) or § 1.6011-4T(b)(6), respectively.

.04 Alternative disclosure procedures for transactions with a significant book-tax difference.

(1) In general. A taxpayer described in section 4.02 or section 4.03 of this revenue procedure is deemed to satisfy the disclosure requirements of § 1.6011-4 with respect to transactions described in § 1.6011-4(b)(6) if the taxpayer discloses on a Schedule M-3 each item of income, gain, loss, deduction, or credit for which the difference between the amount included in the taxpayer's financial statement net income (loss) for the taxable year and the amount included in taxable income for the taxable year ("difference") is greater than $10 million. The taxpayer must separately state and adequately disclose, on the applicable line of Column B and Column C of Part II and Part III of Schedule M-3, each difference that is greater than $10 million. The Schedule M-3 must be completed (and filed in accordance with section 4.04(2) of this revenue procedure) as if the taxpayer were a corporation required to complete and file

Schedule M-3 for that taxable year. For purposes of this section 4.04(1), the rules applicable to a corporation (or U.S. consolidated tax group) required to complete and file Schedule M-3 (for example, guidance provided in the form of instructions to Schedule M-3 (including draft instructions until such instructions are finalized)) will apply, including rules for determining: (i) an item of income, gain, loss, deduction, or credit; (ii) how to separately state and adequately disclose a difference; (iii) whether an item(s) can be combined with another item(s); (iv) the classification of a difference as temporary or permanent; and (v) the information required to be provided for items of partnerships and flow-through entities.

For purposes of this section 4.04(1), the taxpayer's financial statement net income (loss) is the financial statement net income (loss) of the taxpayer if the taxpayer were a corporation required to complete Schedule M-3 (that is, the amount that would be reported on line 11, Part I of Schedule M-3). In addition, in the case of a member of a group of affiliated corporations filing a U.S. consolidated tax return, whether an item of difference exceeds $10 million is based on the separate activity of that group member, and is not based on the consolidated activity of the U.S. consolidated tax group.

(2) Time and manner for complying with the alternative disclosure procedures of section 4.04(1). The Schedule M-3 required under section 4.04(1) of this revenue procedure, and any supporting statements, must be attached to the taxpayer's timely filed original tax return (including extensions). The taxpayer must include its name and identification number on the top of Page 1 of Schedule M-3 and also must include the following statement on the top of Page 1 of Schedule M-3: "Alternative

disclosure under Rev. Proc. 2004-45 for transactions with a significant book-tax difference under § 1.6011-4(b)(6)." In addition, the taxpayer must send a copy of the Schedule M-3 required under section 4.04(1) of this revenue procedure, and any supporting statements, to the Office of Tax Shelter Analysis, Internal Revenue Service LM:PFTG:OTSA, Large & Mid-Size Business Division, 1111 Constitution Ave., NW, Washington, DC 20224, on or before the due date for the taxpayer's timely filed original tax return (including extensions). If a taxpayer does not have a difference in excess of $10 million as determined under section 4.04(1) of this revenue procedure, the taxpayer is not required to file a Schedule M-3 otherwise required by this revenue procedure and the taxpayer also is not required to file Form 8886, Reportable Transaction Disclosure Statement, otherwise required by § 1.6011-4, with respect to transactions described in § 1.6011-4(b)(6).

(3) Use of draft final version of Schedule M-3. For purposes of complying with the alternative disclosure procedures described in section 4.04(1) and (2) of this revenue procedure, a taxpayer must use the most recent draft version of Schedule M-3 (and any guidance provided in the form of instructions to Schedule M-3, including draft instructions) referred to in section 2.03 of this revenue procedure until Schedule M-3 is released in final form.

.05 Effect on other disclosure obligations. This revenue procedure does not affect any of a taxpayer's disclosure obligations under §§ 1.6011-4, 20.6011-4, 25.6011-4, 31.6011-4, 53.6011-4, 54.6011-4, or 56.6011-4 with respect to a transaction

described in one or more of §§ 1.6011-4(b)(2), (b)(3), (b)(4), (b)(5), or (b)(7), even if the transaction also is described under § 1.6011-4(b)(6).

.06 The Service and the Treasury will continue to evaluate whether the disclosure requirements described in this revenue procedure and Schedule M-3 provide the Service and Treasury adequate information regarding significant book-tax differences.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective July 7, 2004.

SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1894.

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.

The collection of information in this revenue procedure is in section 4. The information will be used to determine if taxpayers have complied with the disclosure requirements in § 1.6011-4. This information collection is voluntary. Taxpayers may choose this alternate procedure of disclosing instead of disclosing the information on Form 8886.

The likely respondents are business or other for-profit institutions. The estimated total annual reporting burden associated with this alternative method of compliance is

zero. This is because the burden is already accounted for under control number 1545-1685 which applies to the regulations under § 1.6011-4.

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.

DRAFTING INFORMATION

The principal author of this revenue procedure is Tara P. Volungis of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Volungis at (202) 622-3070 (not a toll-free number). For information regarding Schedule M-3, contact Diane Litecky at (732) 452-8134 (not a toll-free number).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 9, 2004
JS-1849

IRS Collection Policies Unaffected by Ongoing Litigation
IRS To Continue Collecting Communications Excise Taxes

Today the Treasury Department and the Internal Revenue Service issued Notice 2004-57, to inform taxpayers that the IRS will continue to collect the communications excise tax as it always has, notwithstanding ongoing and conflicting litigation.

Individuals and businesses paying for taxable communications services are required to pay the tax to their phone company together with their payment for the services. The phone companies then forward the taxes collected from their customers to the United States Treasury. Failure to pay the tax to the phone company may result in the imposition of penalties and interest. Taxpayers who believe, based on the ongoing litigation, that they do not owe the tax can preserve any rights they may have to a refund, without risking penalties and interest, by paying the tax to the phone company and filing a claim for refund with the IRS.

Current regulations require phone companies to report the failure of their customers to pay the telephone excise tax, but the regulations do not provide a date by which the report is due. Proposed and temporary regulations are being issued today that provide that date.

REPORTS

- The text of notice 2004-57

Part III - Administrative, Procedural, and Miscellaneous

Communications Excise Tax; § 4251

Notice 2004-57

The Internal Revenue Service (Service) has received inquiries concerning the scope of the communications excise tax imposed by § 4251 of the Internal Revenue Code. These inquiries were precipitated, in part, by conflicting results in recent litigation. Compare American Bankers Ins. Group v. United States, 308 F. Supp. 2d 1360 (S.D. Fla. 2004), appeal docketed, No. 04-10720-EE (11th Cir. Feb. 12, 2004) with Office Max, Inc. v. United States, 309 F. Supp. 2d 984 (N.D. Ohio 2004). This notice confirms that the Service will continue to assess and collect the tax under § 4251 on all taxable communications services, including those communications services similar to those at issue in the cases.

Persons paying for taxable communications services (taxpayers) are required to pay the tax to a collecting agent (the person receiving the payment on which tax is imposed), and collecting agents are required to pay over the tax to the United States Treasury and to file the required returns. Taxpayers may preserve any claims for overpayments by filing administrative claims for refund with the Service pursuant to § 6511.

Failure to pay the tax to the collecting agent may result in the imposition of penalties, as well as interest.

DRAFTING INFORMATION

The principal author of this notice is Cynthia A. McGreevy of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice contact Ms. McGreevy at (202) 622-3130 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 10, 2004
JS-1850

Remarks of
Wayne A. Abernathy
Assistant Secretary of the Treasury for Financial Institutions
before the Outreach Meeting of the
Financial and Banking Information Infrastructure Committee
and the
Financial Services Sector Coordinating Council
Orlando, Florida
Relentless in Protecting the Symbols and Sinews of Freedom

The Mission: Preserving Freedom

So far as I can remember, the first bank I ever set foot in was the Deerfield Beach Bank, in the northeast corner of Broward County. While not much taller than the bank counter, that is where I opened up my passbook savings account. And that was where I would go to check for pennies as I began my first coin collection. As a young child, I learned that banks are about savings, the future, and personal service. I have never forgotten that lesson, and through the years I have tended to do my banking with the banks that remembered that lesson the best.

The other lesson I learned as a lad was a lesson of freedom, and how financial services companies facilitate my freedom. Today we are engaged in a new war, with a vicious enemy. This enemy is hidden. He strikes from behind, from disguise, from ambush. He knows no mercy, acknowledges no shame. His target is neither our land nor our wealth. His target is nothing less than our very way of life. It is who we are and how we live that the terrorist seeks to destroy.

Remember, and make no mistake: it is not precisely America--or the United States of America--that the terrorists are fighting. They target what America represents, what made America what it is. They target freedom. Were we to surrender our freedoms, that might be one way to stop the terrorism. They say that terrorists do not thrive in police states, that they prey upon free and open societies. But if we close our society and surrender our freedoms, then the terrorist wins, because it is our freedom--and what freedom does to people--what people do with freedom, free hearts, free minds--this is what the terrorist hates.

President Bush has given to us in this Administration our mission--a mission to be conducting working with the people of this nation--the mission is to vanquish terrorism without surrendering our freedom, to draw upon the power of our freedom to fight and defeat terrorism. The oft quoted and seldom read Alexis de Tocqueville saw a great genius in Americans to associate, to come together freely to achieve important goals. That is the task before us today.

The Symbols and Sinews

As we have been reminded yet again in recent days, pitiless people have their sights set on the symbols and sinews of freedom. Those symbols and sinews include the systems, the relationships, the arrangements, and the institutions that enable people to associate freely here in this nation and from here throughout the world. The haters of freedom despise free markets, free enterprise, and they are targeting the financial institutions that support those free markets.

Today I salute and congratulate you and your colleagues in the financial services industries, you who know that you are in the terrorists' sites, and yet are determined to go on with your important business, knowing that it is your business that helps

millions of others all over the country go on with their business. We will not be cowed, we will not be intimidated, but instead we will respond to threats with renewed effort and determination.

We are assembled here today, as others have in other financial centers around the country, and as others will yet assemble elsewhere, to say that we will not let the terrorists, we will not let the enemies of freedom, we will not let them destroy or disrupt our financial commerce, we will not let them interfere with our ability to save, to invest, to borrow, to insure against life's dangers.

With planning, preparation, and prudence, we can deny the terrorists the prize they seek. They want to make you stop. They want to make you close up shop. They want to make you fear to innovate, to invest, to create new opportunities, new products, new jobs. I firmly believe that if we are prepared, we need not fear.

Good News

I am a good news man. I look for the good news, and I usually find it. There is a good news story here, several stories. First of all, our war against the terrorists continues to progress and bring successes. While the terrorists are plotting, they now know that they have to look over their shoulder, because we are coming after them. We are more relentless than they are. We are finding them, we are exposing their plots. In exposing their plots, we are increasing the chance of frustrating their plots.

Second, because of work done already, our financial systems are stronger and more resilient than ever before. Behind each financial system, each financial service, you are likely to find an alternative system or service, waiting to be called upon. Whether the challenge is a hurricane, a software foul up, or a terrorist attack, when it threatens there is an alternative, often several alternatives, ready for use.

Today, in New York, in northern New Jersey, in Washington the financial sector is at a higher level of alert, we are on watch, on our guard, and back up systems and programs are at the ready. But we are on our guard not just there, but here in Florida, too. The information recently revealed tells us for certain that terrorists are looking at our financial services companies, and we must be careful not to conclude that because we have exposed one plot that there is not another. We must not think that because we are not named in one exposed plot, that we are free from risk. We ask you to look at the exposed patterns and look at your efforts. Ask whether you are taking adequate precautions, are your back up arrangements in order? And look around you. Notice the unusual, the out of place, and share and compare. Today we will discuss some tools to help you do that.

The Essential, Obvious Things to Do

This morning I would like to share with you four principles that should guide our preparations. They should also guide us in our response to calamity, whether manmade calamities or the calamities of nature. I presented these principles to Congress last year, when I explained how well they had worked at the time of the Detroit to New York power black out of last summer.

I recently shared these with members of my family. I could tell that they were not impressed. When I asked them why, they told me in effect that these points were rather obvious. They had me there. I offer in defense the words of Calvin Coolidge, who once said,

> They criticize me for harping on the obvious. Perhaps some day I'll write *On the Importance of the Obvious.* If all the folks in the United States would do the few simple things they know they ought to do, most of our big problems would take care of themselves. (Calvin Coolidge, quoted by Cal Thomas in, "Silent Cal Speaks: Why Calvin Coolidge Is the Model for Conservative Leadership Today," *The Heritage Lecture Series*, No.576, p.3)

These are the four principles. They are presented in order of importance, and I confess that they are obvious. I would add, though, that in times of stress and challenge, the obvious does not always seem so obvious. These points are even

more important than they are obvious:

First, and most important, we must remember in all that we do to protect our financial infrastructure, that it is always about people. It is the people that make our financial institutions work, people that designed the systems, people that make them successful, people that innovate to keep them fresh and dynamic, and it is people whom they are designed to serve, people who rely upon financial services for so many aspects of their daily lives. Our first consideration in planning and action must be, how does it affect people.

Second, because it is about people, it is about confidence. Our financial institutions operate on confidence, but they also promote confidence. In fact, confidence is what our financial institutions must provide, confidence that financial transactions will be carried out, that checks will clear, that bills will be paid, that investments will be made, that insurance promises will be kept. The confidence provided by financial institutions and their services play a big part in helping to cope with the trauma of disaster. With good reason, earned by experience, the world places great confidence in American financial institutions. In our planning and in our action, what are we doing to promote confidence?

Third, essential to that confidence is open markets, financial institutions open for business, doing their business, allowing Americans everywhere to engage in their business, even during--especially during--times of stress. It is important for financial institutions and markets to continue to operate as close to business-as-usual as possible. During times of stress, investors need to price the effects of that stress on assets. The longer they are prevented from pricing the impact, the more anxiety builds and the worse the consequences will be when markets eventually re-open. What do we need to do, in planning and action, to keep our markets open?

The fourth guiding principle is responsibility. Each bank, every insurance company, every single financial institution has a responsibility to its customers. Every regulator has a responsibility to the financial institutions that it supervises. That responsibility applies both as we prepare for disruptions and as we weather them. In the event of a disorder in the payments system, for example, we want the payments systems experts to fix it. We do not want them to wait for guidance from Washington. Just fix it. The experts who are on the ground and in the field are the best to determine what steps should be taken to protect employees and customers. We will help where we can and where we need to, but we leave the responsibility with the financial institutions and the regulators that are closest to the problems to find the solutions. Initiative and ingenuity are the most powerful tools to deal with any disruption, and we must give full room for their exercise. All of us must shoulder our responsibility.

People, confidence, open markets, and responsibility are the four keys, the fundamental principles that guide us. They guide our preparations, and they guide our response. They were tested by that unexpected drill last summer when the lights went out from Detroit to New York, and they worked well. People did not lose money from their accounts, there was no panic, financial markets opened and operated, and there were no calls to Washington from financial leaders asking what to do. They have been tested often since, most recently this past week. Each test shows us better prepared, and outlines where more work needs to be done.

Time for Work

So, there is more work for all of us to do. Your presence and participation here today demonstrate your willingness to roll up your sleeves and do the work.

I was taught that the most important part of prayer is what you do after you get up off of your knees. If today's meetings are to have lasting effect, it will come from what you do when you leave these meetings. Work with your colleagues, consult, share best ideas. We are ready to lend a hand, to assist you in your efforts, all in keeping with the four obvious and absolutely essential principles I have outlined today.

A few weeks ago, I addressed a meeting of financial services leaders in Richmond, Virginia. I brought my youngest son with me that day. He is about the age when I walked into a bank for the first time. He reminds me, he and his generation remind us all, that it is the future, a future of freedom, free markets, free enterprise, free

minds and free homes, that we are preserving, that we are building. There are people in the world who hate all of that, who would destroy it if they could, but we won't let them. As Americans have done in the past, we today will stop them. Thank you for letting me join with you in that effort.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 10, 2004
JS-1851

**Treasury Assistant Secretary for Financial Institutions,
Wayne A. Abernathy Leads Florida Roundtable to Discuss Financial Education
with Local Leaders in Orlando**

Treasury Assistant Secretary for Financial Institutions Wayne Abernathy today led a financial education roundtable, hosted by the InCharge Education Foundation in Orlando, Florida. Abernathy highlighted Treasury's financial education initiatives and the role of the new Financial Literacy and Education Commission established by Title V of the Fair and Accurate Credit Transactions Act. Abernathy and over 15 participants representing Orlando businesses, nonprofits, the academic community and local government also discussed how to improve financial education in Orlando and the country.

"Businesses, schools and local leaders play a key role in improving financial education in their communities. By continuing to work together and identifying best practices for financial education, communities can help people enjoy the benefits of acquiring good personal finance skills," said Abernathy. "By helping to coordinate this important effort, groups like the InCharge Education Foundation improve access to financial education."

The InCharge Education Foundation is a national non-profit organization that specializes in personal finance education and research. The organization promotes financial education through various programs including: Credit Compass, MindYourFinances.com and dinerohispano.com. It publishes the YOUNG MONEY and Military Money magazines, as well as produces the Mike Schiano radio program.

In addition to InCharge Education Foundation staff, over 15 representatives from the private, nonprofit, academic and local government sectors also participated in the forum. The following organizations participated at today's roundtable: Employer Services, Workforce Central Florida; Smith Barney; the University of Kentucky; Hispanic Business Initiative Fund of Greater Orlando; Virginia Tech; Florida Credit Union League - Central Florida Chapter; CCCS of Central Florida & the Florida Gulf Coast; InCharge Debt Solutions; Central Florida Educators' Federal Credit Union; Colonial Bank; Valencia Community College; Central Florida Educators' Federal Credit Union; UCF Federal Credit Union; Center for Economic Education, University of Central Florida; Instruction and Curriculum Services, Orange County Public Schools; and Junior Achievement of Central Florida.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, homeownership and retirement planning. The office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 10, 2004
JS-1852

Treasury Identifies Cuban-Controlled Shipping Entity as a SDN

The U.S. Department of the Treasury today took further action against Fidel Castro's oppressive regime by identifying Melfi Marine, a shipping company controlled by the Cuban government, as a Specially Designated National (SDN) of Cuba.

"With this step, we continue to restrict the Cuban government's access to capital by identifying and isolating companies controlled by Castro," said Juan Carlos Zarate, Treasury's Assistant Secretary for Terrorist Financing. "The Castro government uses money to enrich itself and perpetuate its totalitarian regime at the expense of the Cuban people."

Melfi Marine was incorporated in Panama in 1981 and is a wholly-owned subsidiary of Cimex, identified by the Treasury Department in February 2004 as a SDN of Cuba. Cimex is a holding company owned by the Castro regime. Melfi Marine provides container shipping service between Halifax, Nova Scotia, Canada and Havana, Cuba.

Persons subject to U.S. jurisdiction may not engage in any transactions with Melfi Marine unless authorized by Treasury's Office of Foreign Assets Control (OFAC), and all property of Melfi Marine that is in the possession of persons subject to U.S. jurisdiction is blocked.

Today's action comes on the heels of strengthened measures by the Bush Administration to keep hard currency and travel-related dollars out of Castro's coffers. Treasury's announcement today is in furtherance of President Bush's October 2003 initiative intended to hasten the arrival of a new, free and democratic Cuba by strengthening enforcement of U.S. laws prohibiting travel-related transactions with the island.

With today's announcement, the Treasury Department has now taken action against 12 Castro-controlled entities since President Bush's October 2003 statement.

ENTITY

Melfi Marine Corporation S.A.

a.k.a..: Melfi Marine, S.A.

Addresses:

- Calle Oficios No. 410 e/Luz y Acosta, La Habana Vieja, Habana, Cuba;
- Anillo del Puerto e/Pote y Linea del Ferrocarril, La Habana Vieja, Habana, Cuba;
- Oficios 104, Havana Vieja, Havana, Cuba;
- Oficina 7, Edificio Senorial, Calle 50 Apartado 31, Panama City, 5, Panama.

For more information on previous identifications of entities controlled by the Cuban government, please visit the links below:

- www.treas.gov/press/releases/js1161.htm
- www.treas.gov/press/releases/js1240.htm

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 11, 2004
js-1853

Secretary Snow Visits Florida This Week

U.S. Treasury Secretary John W. Snow will visit Southeastern Florida on Friday, August 13 to meet with local business leaders and discuss the President's efforts to strengthen the economy and create jobs.

"As a result of the President's economic leadership, we have overcome a recession and seen 11 straight months of job creation, totaling nearly 1.5 million new U.S. jobs since August 2003," said Secretary Snow. "So far this year, Florida has gained nearly 82,000 new jobs and the President's tax reform policies have ensured that more than 6.1 million Florida taxpayers will have lower income tax bills in 2004."

During this trip to Florida, expect Secretary Snow to also discuss the Administration's efforts to control health care costs, reduce frivolous lawsuits and ensure that America has reliable and affordable sources of energy.

Recent indicators show that President Bush's economic policies continue to move the economy forward. According to the Labor Department, the national unemployment rate declined to 5.5% in July – down 0.8 percentage point from a peak of 6.3% in June 2003 and the lowest rate since October 2001. At 5.5%, the unemployment rate is below the average of the 1970s, 1980s, and 1990s. Employment over the last year was up in 46 of the 50 states and the unemployment rate was down in all regions and in 47 of the 50 states.

The following events are open to the media, which must present media credentials or photo ID:

Friday, August 13

Roundtable Discussion with Local Business Leaders
Greater Boca Raton Chamber of Commerce and South Florida Business Alliance
9:30 am EDT
Nabi Biopharmaceuticals
5800 Park of Commerce Blvd., N.W.
Boca Raton, FL
** Media should arrive by 8:45 am

Tour of Nabi Biopharmaceuticals
10:30 am EDT
Nabi Biopharmaceuticals
5800 Park of Commerce Blvd., N.W.
Boca Raton, FL
Press Conference – Treasury Secretary Snow and U.S. Congressman E. Clay Shaw
11:30 am EDT
Nabi Biopharmaceuticals
5800 Park of Commerce Blvd., N.W.
Boca Raton, FL

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 11, 2004
js-1854

Treasury Provides Guidance on Classification of Business Entities Organized In Multiple Jurisdictions

Today the Treasury Department issued temporary and proposed regulations regarding the proper classification for federal tax purposes of business entities organized in multiple jurisdictions.

In general, the status of a business entity for tax purposes – for example, as a corporation or as some other type of entity such as a partnership – depends on its form of organization. Under existing final regulations, entities that take certain forms in their country of organization generally are treated as corporations. Treasury and the IRS are aware, however, that some taxpayers have taken the position that the fact that an entity takes one of these corporate forms of organization may be disregarded if the entity takes a different form in another jurisdiction. This position is erroneous because all aspects of an entity's organization must be taken into account when determining its status. Accordingly, the temporary and proposed regulations make clear that, when an entity is organized in more than one jurisdiction, it is treated as a corporation for tax purposes if it takes a corporate form in any jurisdiction.

Generally, for tax purposes, a business entity is considered to be a domestic entity if it is organized in the United States, and is considered to be a foreign entity only if it is not organized in the United States. Accordingly, the temporary and proposed regulations make clear that, when a business entity is organized both in the United States and in a foreign jurisdiction, it is treated as a domestic entity for federal tax purposes.

The texts of the temporary and proposed regulations are attached.

REPORTS

- Temporary Regulations
- Proposed Regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[TD 9153]

RIN 1545-BD43

Clarification of Definitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations providing clarification of the definitions of a corporation and a domestic entity in circumstances where the business entity is considered to be created or organized in more than one jurisdiction. These regulations will affect business entities that are created or organized under the laws of more than one jurisdiction. The final regulations consist of technical revisions to reflect the issuance of the temporary regulations and to correct a cross-reference in §301.7701-3. The text of the 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 Date: These regulations are effective August 12, 2004.

Applicability Dates: For the dates of applicability of these regulations, see §301.7701-2T(f) and §301.7701-5T(c).

FOR FURTHER INFORMATION CONTACT: Thomas Beem, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Several jurisdictions have recently enacted provisions (generally referred to as either continuance or domestication statutes) that make it possible for a business entity to be treated as created or organized under the laws of more than one jurisdiction at the same time (a dually chartered entity). A dually chartered entity and the interest holders in the entity must determine for Federal tax purposes (1) the entity's classification (e.g., corporation or partnership) and (2) whether the entity is foreign or domestic. The regulations contained in this document are intended to clarify the rules for these determinations.

Section 7701(a)(3) of the Internal Revenue Code of 1986 (Code) provides that the term corporation includes associations, joint stock companies, and insurance companies. The definition of a corporation under the tax statutes has not changed since the Revenue Act of 1918, Public Law 65-254 (40 Stat. 1057, section 1). Final regulations (TD 8697) providing rules for the classification of business entities were published in the Federal Register on December 18, 1996 (61 FR 66584 (1996)). Those entity classification rules identify certain entities that are always treated as corporations and are not eligible to elect their entity classification.

Section 7701(a)(4) of the Code provides that the term domestic when applied to a corporation or partnership means "created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations." Section 7701(a)(5) of the Code provides that the term foreign when applied to a corporation or partnership means a "corporation or partnership that is not domestic." This definition is significantly different than the definition of foreign entity that preceded it. The Revenue Act of 1918 used the term foreign to mean a corporation or partnership "created or organized outside the United States." Thus, under that definition, a dually chartered entity that was organized in the United States and in a foreign jurisdiction would have met the definitions of both a domestic entity and a foreign entity, creating uncertainty as to

the entity's status. The Revenue Act of 1924, Public Law 68-176 (43 Stat. 253) eliminated that potential for uncertainty by providing the definition of a foreign entity that is currently reflected in section 7701(a)(5). This definition of a foreign entity as "a corporation or partnership that is not domestic" makes it impossible for an entity to meet the definitions of both a domestic entity and a foreign entity for Federal tax purposes at the same time. As a result, a dually chartered entity that is organized both in the United States and in a foreign jurisdiction is a domestic entity.

Final regulations providing further guidance on the definitions of domestic and foreign business entities were published in the Federal Register on November 17, 1960 (25 FR 10928 (1960)).

Explanation of Provisions

Under the existing rules, the characterization of a business entity for Federal tax purposes is established in two separate and independent steps. The first involves a determination of whether the entity is a corporation or a non-corporate entity (e.g., a partnership). The second involves a determination of whether the entity is foreign or domestic.

The determination of whether a business entity is classified as a corporation is made by applying the definition in §301.7701-2(b). If the entity is not a corporation under that definition, then it is a partnership if it has more than one owner and it is a disregarded entity if it has only a single owner. The temporary regulations in this document clarify that this same definition applies to dually chartered entities. Thus, to determine whether a dually chartered entity is a corporation, it must first be determined if the entity's organization in any of the jurisdictions in which it is organized would cause it to be treated as a corporation under the rules of §301.7701-2(b). If the entity would be treated as a corporation as a result of its formation in any of the jurisdictions in which it is organized, it is treated as a corporation for Federal tax purposes even though its organization in the other jurisdiction or jurisdictions would not have caused it to be treated as a corporation.

Once the classification of a business entity has been determined, a determination will generally need to be made regarding whether it is a domestic or foreign entity. It is a domestic entity if it is created or organized in the United States or under the laws of the United States or of any state. It is a foreign entity only if it is not domestic. The temporary regulations in this document revise §301.7701-5 to clarify that a dually chartered entity is domestic if it is organized as any form of entity in the United States, regardless of how it is organized in any foreign jurisdiction. An entity that is classified as a corporation because of its form of organization in a foreign country is considered a domestic corporation if it is also organized as some form of entity in the United States, regardless of what form the entity takes in the United States (e.g., corporation, limited liability company, or partnership).

These temporary regulations also remove from §301.7701-5 the definitions of resident foreign corporation, nonresident foreign corporation, resident partnership and nonresident partnership because these terms have become obsolete due to statutory changes since the final regulations were published in 1960.

These regulations clarify current law and do not change the outcome that would result under a proper application of the existing rules as they apply to dually chartered entities. For example, the temporary regulations are consistent with the result in Rev. Rul. 88-25 (1988-1 C.B. 116). These regulations are also not intended to affect the result under existing rules regarding whether an organization is a separate entity for Federal tax purposes (e.g., whether, in a particular case, two sets of organizational documents constitute different facets of a single entity or the foundations of two separate entities). In addition, if a business entity undertakes a continuance, domestication, or other transaction that, upon application of these rules, changes its entity classification or changes its foreign or domestic status, the tax effects of that transaction are determined under the regular tax principles that apply to such changes. Finally, the regulations contained in this document do not determine an entity's place of residence for the purpose of applying the provisions of a tax treaty.

Section 7701(a)(4) of the Code provides regulatory authority to define a domestic partnership other than based on where the partnership is created or organized. The Treasury and the IRS are continuing to explore whether, and under what circumstances, a different definition may be appropriate. If any change to the definition of a domestic partnership were to be proposed, it would apply only to partnerships created or organized after the issuance of regulations or other guidance substantially describing the change in definition.

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 notice of proposed rulemaking published in the proposed rules section in this issue of the **Federal Register**. Pursuant to section 7806(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

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

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and Recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301 -- PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. In §301.7701-1, paragraph (d) is revised to read as follows:

§301.7701-1 Classification of organizations for federal tax purposes.

* * * * *

(d) Domestic and foreign business entities. [Reserved]. For further guidance, see §301.7701-1T.

* * * * *

Par 3. Section 301.7701-1T is added to read as follows:

§301.7701-1T Classification of organizations for federal tax purposes (temporary).

(a) through (c) [Reserved]. For further guidance, see §301.7701-1(a) through (c).

(d) Domestic and foreign entities. See §301.7701-5T for the rules that determine whether a business entity is domestic or foreign.

(e) through (f) [Reserved].

Par. 4. In §301.7701-2, paragraph (b)(9) is added to read as follows:

§301.7701-2 Business entities; definitions.

* * * * *

(b) * * *

(9) [Reserved]. For further guidance, see §301.7701-2T(b)(9).

* * * * *

Par. 5. Section 301.7701-2T is added to read as follows:

§301.7701-2T Business entities; definitions (temporary).

(a) through (b)(8) [Reserved] For further guidance, see §301.7701-2 (a) through (b)(8).

(b)(9) Entities with multiple charters. (i) An entity created or organized under the laws of more than one jurisdiction if the rules of this section would treat it as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized. (The

determination of a business entity's classification is made independently of the determination whether the entity is domestic or foreign. See §301.7701-5T for the rules that determine whether a business entity is domestic or foreign.)

(ii) Examples. The following examples illustrate the rule of this paragraph (b)(9):

Example 1. (i) Facts. X is an entity with a single owner organized under the laws of Country A as an entity that is specifically mentioned in paragraph (b)(8)(i) of this section. Under the rules of this section, such an entity generally is a corporation for Federal tax purposes. Several years after its formation, X files a certificate of domestication in State B as a limited liability company (LLC). Under the laws of State B, X is considered to be created or organized in State B as a LLC upon the filing of the certificate of domestication and is therefore subject to the laws of State B. Under the rules of this section and §301.7701-3, a LLC with a single owner organized only in State B is disregarded as an entity separate from its owner for Federal tax purposes (absent an election to be treated as an association). Neither Country A nor State B law requires X to terminate its charter in Country A as a result of the domestication, and in fact X does not terminate its charter in Country A. Consequently, X is now organized in more than one jurisdiction.

(ii) Result. X remains organized under the laws of Country A as an entity that is specifically mentioned in §301.7701-2(b)(8)(i), and as such, it is an entity that generally is treated as a corporation under the rules of this section. Therefore, X is a corporation for Federal tax purposes because the rules of this section would treat X as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

Example 2. (i) Facts. Y is an entity that is incorporated under the laws of State A and that has two shareholders. Under the rules of this section, an entity incorporated under the laws of State A is a corporation for Federal tax purposes. Several years after its formation, Y files a certificate of continuance in Country B as an unlimited company. Under the laws of Country B, upon filing a certificate of continuance, Y is treated as organized in Country B. Under the rules of this section and §301.7701-3, an unlimited company organized only in Country B that has more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). Neither State A nor Country B law requires Y to terminate its charter in State A as a result of the continuance, and in fact Y does not terminate its charter in State A. Consequently, Y is now organized in more than one jurisdiction.

(ii) Result. Y remains organized in State A as a corporation, an entity that is treated as a corporation under the rules of this section. Therefore, Y is a corporation for Federal tax purposes because the rules of this section would treat Y as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

Example 3. (i) Facts. Z is an entity that has more than one owner and that is recognized under the laws of Country A as an unlimited company organized in Country A. Under the rules of this section and §301.7701-3, an unlimited company organized only in Country A with more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). At the time Z was formed, it was also organized as a public limited company under the laws of Country B. Under the rules of this section, a public limited company organized only in Country B generally is treated as a corporation for Federal tax purposes.

(ii) Result. Z is organized in Country B as a public limited company, an entity that generally is treated as a corporation under the rules of this section. Therefore, Z is a corporation for Federal tax purposes because the rules of this section would treat Z as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

(c) through (e) [Reserved]. For further guidance, see §301.7701-2(c) through (e).

(f) Special effective date. The rules of this section apply as of August 12, 2004, to all business entities existing on or after that date.

Par. 6. In §301.7701-3, the last sentence of paragraph (b)(3)(i) is revised to read as follows:

§301.7701-3 Classification of certain business entities.

* * * * *

(b) * * *

(3) * * * (i) * * *For special rules regarding the classification of such entities prior to the effective date of this section, see paragraph (h)(2) of this section.

* * * * *

Par. 7. Section 301.7701-5 is revised to read as follows:

§301.7701-5 Domestic and foreign business entities. [Reserved]. For further guidance, see §301.7701-5T.

Par. 8. Section 301.7701-5T is added to read as follows:

§301.7701-5T Domestic and foreign business entities (temporary)

(a) Domestic and foreign entities. A business entity (including an entity that is disregarded as separate from its owner) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or of any State. Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. A business entity (including an entity that is disregarded as separate from its owner) is foreign if it is not domestic. (The determination of whether an entity is domestic is made independently of the determination of its

classification for Federal tax purposes. See §§301.7701-2, 301.7701-2T, and 301.7701-3 for the rules governing the classification of entities.)

(b) Examples. The following examples illustrate the rules of this section:

Example 1. (i) Facts. Y is an entity that is created or organized under the laws of Country A as a public limited company. It is also an entity that is organized as a limited liability company (LLC) under the laws of State B. Y has been classified as a corporation for Federal tax purposes under the rules of §§301.7701-2, 301.7701-2T, and 301.7701-3.

(ii) Result. Y is a domestic corporation because it is an entity that is classified as a corporation and it is organized as an entity under the laws of State B.

Example 2. (i) Facts. P is an entity with more than one owner organized under the laws of Country A as an unlimited company. It is also an entity that is organized as a general partnership under the laws of State B. P has been classified as a partnership for Federal tax purposes under the rules of §§301.7701-2, 301.7701-2T, and 301.7701-3.

(ii) Result. P is a domestic partnership because it is an entity that is classified as a partnership and it is organized as an entity under the laws of State B.

(c) Effective date. The rules of this section apply as of August 12, 2004,

to all business entities existing on or after that date.

Mark E. Matthews
Deputy Commissioner for Services and Enforcement.

Approved: July 21, 2004

Gregory Jenner
Acting Assistant Secretary of the Treasury.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[REG-124872-04]

RIN 1545-BD37

Clarification of Definitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: This issue of the **Federal Register** contains temporary regulations that provide clarification of the definitions of a corporation and a domestic entity in circumstances where the business entity is considered to be created or organized in more than one jurisdiction. These regulations will affect business entities that are created or organized under the laws of more than one jurisdiction. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and must be received by November 10, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 3, 2004 must be received by October 15, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-124872-04), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday (excluding Federal holidays) between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-124872-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC or sent electronically, via either the IRS internet site at www.irs.gov/regs or the Federal eRulemaking Portal at

www.regulations.gov (IRS and REG-124872-04). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Thomas Beem, (202) 622-3860; concerning submissions of comments or the public hearing, Sonya Cruse, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the **Federal Register** amend 26 CFR part 301 relating to section 7701 of the Internal Revenue Code of 1986 (Code). The temporary regulations provide guidance as to the definitions of a corporation and of domestic and foreign entities in circumstances in which an entity is created or organized under the laws of more than one jurisdiction (a dually chartered entity). The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains both 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 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 7806(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are 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 November 3, 2004 at 10:00 a.m. in the Auditorium of the Internal Revenue building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area earlier than 30 minutes prior to the start of the hearing. 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 this hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time devoted to each topic (signed original and eight (8) copies) by October 15, 2004. A period of ten minutes will be allotted to each person for making comments. An agenda showing the scheduling of 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.

Proposed Effective Date

The regulations proposed in this document would apply on August 12, 2004, to all business entities existing on or after that date.

Drafting Information

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

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and Recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301 -- PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. In §301.7701-1, paragraph (d) is revised to read as follows:

§301.7701-1 Classification of organizations for federal tax purposes.

* * * * *

(d) [The text of the proposed amendment revising §301.7701-1(d) is the same as the text of §301.7701-1T(d) published elsewhere in this issue of the **Federal Register**.]

* * * * *

Par. 3. In §301.7701-2 paragraph (b)(9) is added to read as follows:

§301.7701-2 Business entities; definitions.

* * * * *

(b) * * *

(9) [The text of the proposed amendment adding §301.7701-2(b)(9) is the same as the text of §301.7701-2T(b)(9) published elsewhere in this issue of the **Federal Register**.]

* * * * *

Par. 4. Section 301.7701-5 is revised to read as follows:

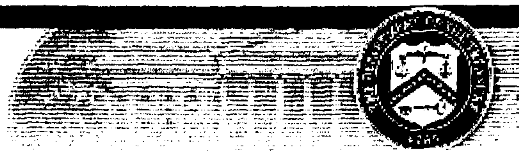
§301.7701-5 Domestic and foreign business entities.

[The text of the proposed amendment revising §301.7701-5 is the same as the text of

§301.7701-5T published elsewhere in this issue of the **Federal Register**.]

Mark E. Matthews
Deputy Commissioner for Services and Enforcement.

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

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August 12, 2004
JS-1855

Treasury and IRS Issue Regulations on Lifo Recapture for S Corporations that Own Partnership Interests

The Treasury Department and the Internal Revenue Service today issued proposed regulations providing that a corporation that elects to become an S corporation must recapture its portion of the LIFO inventory benefit of a partnership in which the electing corporation holds a partnership interest.

Under the LIFO recapture rules, a C corporation that inventories goods under the LIFO (last-in, first-out) method of accounting and that elects to be taxed as an S corporation must include in its gross income the LIFO recapture amount. The LIFO recapture amount is the amount of income that the corporation has deferred by using the LIFO method rather than the FIFO method. The proposed regulations would require a corporation that converts to S status to take into account a LIFO recapture amount with respect to its share of LIFO inventory held in a partnership in which the corporation holds a partnership interest.

REPORTS

- The text of the proposed regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-149524-03]

RIN 1545-BC66

LIFO Recapture Under Section 1363(d)

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations regarding LIFO recapture by corporations converting from C corporations to S corporations. The purpose of the proposed regulations is to provide guidance on the LIFO recapture requirement when the corporation holds inventory accounted for under the last-in, first-out (LIFO) method (LIFO inventory) indirectly through a partnership. The proposed regulations affect C corporations that own interests in partnerships holding LIFO inventory and that elect to be taxed as S corporations or that transfer such partnership interests to S corporations in nonrecognition transactions. The proposed regulations also affect S corporations receiving such partnership interests from C corporations in nonrecognition transactions.

DATES: Written or electronic comments must be received by November 12, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Wednesday, December 8, 2004 must be received by Wednesday, November 17, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-149524-03), room 5203,

Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-149524-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC or submitted electronically via the IRS Internet site at: http://www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-149524-03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Pietro Canestrelli, 202-622-3060, or Martin Schäffer, 202-622-3070; concerning submissions, Robin Jones, 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 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). 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 October 12, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper

performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (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 can be minimized, including through the application of automated collection techniques or other forms of information technology; and

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

The collection of information in this proposed regulation is in §1.1363-2(e)(3). This information is required to inform the IRS of partnerships electing to increase the basis of inventory to reflect any amount included in a partner's income under section 1363(d). Thus, the collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The burden for the collection of information in §1.1363-2(e)(3) is reflected on Form 1065, "Partnership Return of Income".

The estimated burden for the collection of information in §1.1363-2(e)(3) is as follows:

Estimated total annual reporting burden: 200 hours.

The estimated annual burden per respondent varies from 1 to 3 hours, depending on individual circumstances, with an estimated average of 2 hours.

Estimated number of respondents: 100.

Estimated annual frequency of responses: On occasion.

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 contains proposed amendments to 26 CFR Part 1 under section 1363(d) of the Internal Revenue Code (Code). Section 1363(d)(1) provides that a C corporation that owns LIFO inventory and that elects under section 1362(a) to be taxed as an S corporation must include in its gross income for its final tax year as a C corporation the LIFO recapture amount. Under section 1363(d)(3), the LIFO recapture amount is the excess of the inventory amount of the inventory using the first-in, first-out (FIFO) method (the FIFO value) over the inventory amount of the inventory using the LIFO method (the LIFO value) at the close of the corporation's final tax year as a C corporation (essentially, the

amount of income the corporation has deferred by using the LIFO method rather than the FIFO method).

Final regulations (TD 8567) under section 1363(d) were published in the **Federal Register** on October 7, 1994 (59 FR 51105) to describe the recapture of LIFO benefits when a C corporation that owns LIFO inventory elects to become an S corporation or transfers LIFO inventory to an S corporation in a nonrecognition transaction. The final regulations do not explicitly address the indirect ownership of inventory through a partnership. These proposed regulations provide guidance for situations in which a C corporation that owns LIFO inventory through a partnership (or through tiered partnerships) converts to an S corporation or transfers its partnership interest to an S corporation in a nonrecognition transaction.

Section 1374, modified as part of the repeal of the General Utilities doctrine, see General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), imposes a corporate level tax on certain income or gain recognized by an S corporation to the extent the income or gain is attributable to appreciation that occurred while the assets were held by a C corporation. Specifically, section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation. The tax is imposed only during the 10-year period beginning on the first day the corporation is an S corporation. In addition, section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that the S corporation acquires if the S corporation's bases in

such assets are determined (in whole or in part) by reference to the bases of such assets (or any other property) in the hands of a C corporation. This tax is imposed only during the 10-year period beginning on the date that the S corporation acquires the assets.

In Announcement 86-128 (1986-51 I.R.B. 22), the IRS stated that, for purposes of section 1374(d)(2)(A), the inventory method used by a taxpayer for tax purposes (FIFO, LIFO, etc.) shall be used in determining whether goods disposed of following a conversion from C corporation to S corporation status were held by the corporation at the time of conversion. After the issuance of this announcement, Congress became concerned that taxpayers owning LIFO inventory might avoid the built-in gain rules of section 1374. Congress believed that taxpayers owning LIFO inventory, who have enjoyed the deferral benefits of the LIFO method during their status as a C corporation, should not be treated more favorably than their FIFO counterparts. To eliminate this potential disparity in treatment, Congress enacted section 1363(d) in 1987, requiring a taxpayer owning LIFO inventory to recapture the benefits of using the LIFO method. H.R. Rep. No. 100-391 (Parts 1 and 2), 1098 (1987).

In Coggin Automotive Corp. v. Commissioner, 292 F.3d 1326 (11th Cir. 2002), rev'g 115 T.C. 349 (2000), a holding company owned majority interests in several subsidiaries that operated automobile dealerships owning LIFO inventory. As part of a restructuring, each subsidiary contributed its assets (including its LIFO inventory) to a different partnership. The subsidiaries were then merged into the holding company, which elected to be taxed as an S corporation. The court of appeals held that the holding company's S

corporation election did not trigger LIFO recapture under section 1363(d) because it was the partnerships in which the holding company held interests, and not the holding company itself, that used the LIFO method.

Section 337(d)(1) authorizes the Secretary to prescribe regulations to prevent the circumvention of the purposes of the repeal of the General Utilities doctrine through the use of any provision of law or regulations. The Treasury Department and the IRS believe that these proposed regulations are necessary to implement General Utilities repeal. Congress enacted section 1363(d) because the use of the LIFO method by a C corporation that converts to S corporation status creates the potential for the permanent avoidance of corporate level tax on the built-in gain reflected in the LIFO reserve. This avoidance possibility is present regardless of whether the converting corporation owns inventory directly or indirectly through a partnership or tiered partnerships. Accordingly, the Treasury Department and the IRS believe it is appropriate to require the recapture of a converting corporation's share of the LIFO reserves of partnerships in which it participates. Such an approach is consistent with the regulations under section 1374, which generally adopt a lookthrough approach to partnerships.

Explanation of Provisions

The proposed regulations provide that a C corporation that holds an interest in a partnership owning LIFO inventory must include the lookthrough LIFO recapture amount in its gross income where the corporation either elects to be an S corporation or transfers its interest in the partnership to an S corporation in a nonrecognition transaction. The

proposed regulations define the lookthrough LIFO recapture amount as the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704-3, if the partnership sold all of its LIFO inventory for the FIFO value. A corporate partner's lookthrough LIFO recapture amount must be determined, in general, as of the day before the effective date of the S corporation election or, if the recapture event is a transfer of a partnership interest to an S corporation, the date of the transfer (the recapture date). The proposed regulations provide that, if a partnership is not otherwise required to determine inventory values on the recapture date, the lookthrough LIFO recapture amount may be determined based on inventory values of the partnership's opening inventory for the year that includes the recapture date.

The proposed regulations provide that a corporation owning LIFO inventory through a partnership must increase its basis in its partnership interest by the lookthrough LIFO recapture amount. The proposed regulations also allow the partnership through which the LIFO inventory is owned to adjust the basis of partnership inventory (or lookthrough partnership interests held by that partnership) to account for LIFO recapture. This adjustment to basis is to be patterned in manner and effect after the adjustment in section 743(b). Thus, the basis adjustment constitutes an adjustment to the basis of the LIFO inventory (or lookthrough partnership interests held by that partnership) with respect to the corporate partner only; no adjustment is made to the partnership's common basis. The IRS and the Treasury Department request comments on whether the partnership should be required, in some or all circumstances, to increase the basis of partnership assets by the

lookthrough LIFO recapture amount attributable to those assets.

Under §1.1374-4(i)(1), an S corporation's distributive share of partnership items is not taken into account in determining the S corporation's share of net recognized built-in gain or loss if the S corporation's partnership interest represents less than 10 percent of the partnership capital and profits and has a fair market value of less than $100,000. This exception reduces the burden on the S corporation and the partnership of tracking built-in gain assets that are relatively small in amount.

The burden of looking through a partnership interest under section 1374 is greater than the burden of looking through a partnership interest under section 1363(d). Under section 1374, partnership assets must be tracked for a 10-year period. No such tracking problem exists under section 1363 because recapture generally occurs on the date of the S election. Accordingly, the proposed regulations do not contain an exception for partnership interests that are smaller than a specified threshold.

Proposed Effective Date

These regulations are proposed to apply to S elections and transfers made on or after August 13, 2004. No inference is intended as to the tax consequences of S elections and transfers made before the effective date of these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 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. This certification is based upon the fact that few corporations engage in the type of transactions that are subject to these regulations (the conversion from C corporation to S corporation status while holding an interest in a partnership that owns LIFO inventory or the transfer of an interest in such a partnership by a C corporation to an S corporation in a nonrecognition transaction). Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, 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 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 Wednesday, December 8, 2004 beginning at 10:00 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information

about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Wednesday, November 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 authors of these regulations are Martin Schäffer and Pietro Canestrelli, Office of Associate Chief Counsel (Passthroughs and Special Industries). 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.

Proposed Amendments to the Regulations

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

PART 1--INCOME TAXES

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

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

Section 1.1363-2 also issued under 26 U.S.C. 337(d). * * *

Par. 2. Section 1.1363-2 is amended by:

1. Redesignating paragraphs (b), (c), and (d) as paragraphs (d), (e), and (g), respectively.

2. Adding paragraphs (b), (c), (f), and (g)(3).

3. Revising newly designated paragraphs (d) and (e).

The revisions and additions read as follows:

' 1.1363-2 Recapture of LIFO benefits.

* * * * *

(b) LIFO inventory held indirectly through partnership. A C corporation must include the lookthrough LIFO recapture amount (as defined in paragraph (c)(2) of this section) in its gross income--

(1) In its last taxable year as a C corporation if, on the last day of the corporation's last taxable year before its S corporation election becomes effective, the corporation held a lookthrough partnership interest (as defined in paragraph (c)(1) of this section); or

(2) In the year of transfer by the C corporation to an S corporation of a lookthrough partnership interest if the corporation transferred its lookthrough partnership interest to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred interest constitutes transferred basis property (within the meaning of section 7701(a)(43)).

(c) Definitions--(1) Lookthrough partnership interest. A partnership interest is a lookthrough partnership interest if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the last-in, first-out (LIFO) method (LIFO inventory).

(2) Lookthrough LIFO recapture amount. For purposes of this section, a corporation's lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704-3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the first-in, first-out method of accounting authorized by section 471. The lookthrough LIFO recapture amount generally shall be determined as of the end of the recapture date. However, if the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, the partnership may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year that includes the recapture date. For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes inventory distributed by the partnership to a partner on or before the recapture date.

(3) Recapture date. In the case of a transaction described in paragraph (b)(1) of this section, the recapture date is the day before the effective date of the S corporation

election. In the case of a transaction described in paragraph (b)(2) of this section, the recapture date is the date of the transfer of the partnership interest to the S corporation (but only the portion of that date that precedes the transfer).

(d) Payment of tax. Any increase in tax caused by including the LIFO recapture amount or the lookthrough LIFO recapture amount in the gross income of the C corporation is payable in four equal installments. The C corporation must pay the first installment of this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corporation if paragraph (a)(1) or (b)(1) of this section applies, or for the taxable year of the transfer if paragraph (a)(2) or (b)(2) of this section applies. The three succeeding installments must be paid--

(1) For a transaction described in paragraph (a)(1) or (b)(1) of this section, by the corporation that made the election under section 1362(a) to be an S corporation, on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and

(2) For a transaction described in paragraph (a)(2) or (b)(2) of this section, by the transferee S corporation on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.

(e) Basis adjustments--(1) General rule. Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under paragraph (a) of this section.

(2) LIFO inventory owned through a partnership--(i) Basis of corporation's

partnership interest. Appropriate adjustments to the basis of the corporation's lookthrough partnership interest are to be made to reflect any amount included in income under paragraph (b) of this section.

(ii) Basis of partnership assets. A partnership directly holding LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that LIFO inventory. In addition, a partnership that holds, through another partnership, LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that partnership interest. Any adjustment under this paragraph (e)(2) to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. Likewise, any adjustment under this paragraph (e)(2) to the basis of a lookthrough partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to the interest. A basis adjustment under this paragraph (e)(2) is treated in the same manner and has the same effect as an adjustment to the basis of partnership property under section 743(b). See §1.743-1(j).

(3) Election. A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corporation election or transfer described in paragraph (b) of this section. This statement shall state that the partnership is electing under §1.1363-2(e)(3) and must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax under paragraph (d) of this section and of the partnership, as well as the amount of the adjustment and the portion of the adjustment that is attributable to each pool of inventory or lookthrough partnership interest that is held by the partnership.

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

Example 1. (i) G is a C corporation with a taxable year ending on June 30. GH is a partnership with a calendar year taxable year. G has a 20 percent interest in GH. The remaining 80 percent interest is owned by an individual. On April 25, 2005, G contributed inventory that is LIFO inventory to GH, increasing G's interest in the partnership to 50 percent. GH holds no other LIFO inventory. G elects to be an S corporation effective July 1, 2005. The recapture date is June 30, 2005 under paragraph (c)(3) of this section. GH determines that the FIFO and LIFO values of the opening inventory for GH's 2005 taxable year, including the inventory contributed by G, are $200 and $120, respectively.

(ii) Under paragraph (c)(1) of this section, GH is not required to determine the FIFO and LIFO values of the inventory on the recapture date. Instead, GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. For this purpose, under paragraph (c)(2) of this section, the opening inventory includes the inventory contributed by G. The amount by which the FIFO value ($200) exceeds the LIFO value ($120) in GH's opening inventory is $80. Thus, if GH sold all of its LIFO inventory for $200, it would recognize $80 of income. G's lookthrough LIFO recapture amount is $80, the amount of income that would be allocated to G, taking into account section 704(c) and §1.704-3, if GH sold all of its LIFO inventory for the FIFO value. Under paragraph (b)(1) of this section, G must include $80 in income in its taxable year ending on June 30, 2005. Under paragraph (e)(2) of this section, G must increase its basis in its interest in GH by $80.

Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, GH may elect to increase the basis (with respect to G only) of its LIFO inventory by $80.

Example 2. (i) J is a C corporation with a calendar year taxable year. JK is a partnership with a calendar year taxable year. J has a 30 percent interest in the partnership. JK owns LIFO inventory that is not section 704(c) property. J elects to be an S corporation effective January 1, 2005. The recapture date is December 31, 2004 under paragraph (c)(3) of this section. JK determines that the FIFO and LIFO values of the inventory on December 31, 2004 are $240 and $140, respectively.

(ii) The amount by which the FIFO value ($240) exceeds the LIFO value ($140) on the recapture date is $100. Thus, if JK sold all of its LIFO inventory for $240, it would recognize $100 of income. J's lookthrough LIFO recapture amount is $30, the amount of income that would be allocated to J if JK sold all of its LIFO inventory for the FIFO value (30 percent of $100). Under paragraph (b)(1) of this section, J must include $30 in income in its taxable year ending on December 31, 2004. Under paragraph (e)(2) of this section, J must increase its basis in its interest in JK by $30. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, JK may elect to increase the basis (with respect to J only) of its inventory by $30.

(g) Effective dates. * * *

(3) The provisions of paragraphs (b), (c), (e)(2), (e)(3), and (f) of this section apply to S elections and transfers made on or after August 13, 2004.

Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

SS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 11, 2004
2004-8-11-10-11-58-8612

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 $82,145 million as of the end of that week, compared to $82,039 million as of the end of the prior week.

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

	July 30, 2004			August 6, 2004		
TOTAL		82,039			82,145	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	10,795	14,121	24,916	11,044	14,293	25,337
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	10,694	2,838	13,532	10,913	2,872	13,785
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]			19,961			19,393
3. Special Drawing Rights (SDRs) [2]			12,586			12,586
4. Gold Stock [3]			11,045			11,044
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	July 30, 2004			August 6, 2004		
	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

	July 30, 2004			August 6, 2004		
	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 IMF data for the prior month end.

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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August 9, 2004
JS-1849

IRS Collection Policies Unaffected by Ongoing Litigation
IRS To Continue Collecting Communications Excise Taxes

Today the Treasury Department and the Internal Revenue Service issued Notice 2004-57, to inform taxpayers that the IRS will continue to collect the communications excise tax as it always has, notwithstanding ongoing and conflicting litigation.

Individuals and businesses paying for taxable communications services are required to pay the tax to their phone company together with their payment for the services. The phone companies then forward the taxes collected from their customers to the United States Treasury. Failure to pay the tax to the phone company may result in the imposition of penalties and interest. Taxpayers who believe, based on the ongoing litigation, that they do not owe the tax can preserve any rights they may have to a refund, without risking penalties and interest, by paying the tax to the phone company and filing a claim for refund with the IRS.

Current regulations require phone companies to report the failure of their customers to pay the telephone excise tax, but the regulations do not provide a date by which the report is due. Proposed and temporary regulations are being issued today that provide that date.

REPORTS

- The text of notice 2004-57

Part III - Administrative, Procedural, and Miscellaneous

Communications Excise Tax; § 4251

Notice 2004-57

The Internal Revenue Service (Service) has received inquiries concerning the scope of the communications excise tax imposed by § 4251 of the Internal Revenue Code. These inquiries were precipitated, in part, by conflicting results in recent litigation. Compare American Bankers Ins. Group v. United States, 308 F. Supp. 2d 1360 (S.D. Fla. 2004), appeal docketed, No. 04-10720-EE (11th Cir. Feb. 12, 2004) with Office Max, Inc. v. United States, 309 F. Supp. 2d 984 (N.D. Ohio 2004). This notice confirms that the Service will continue to assess and collect the tax under § 4251 on all taxable communications services, including those communications services similar to those at issue in the cases.

Persons paying for taxable communications services (taxpayers) are required to pay the tax to a collecting agent (the person receiving the payment on which tax is imposed), and collecting agents are required to pay over the tax to the United States Treasury and to file the required returns. Taxpayers may preserve any claims for overpayments by filing administrative claims for refund with the Service pursuant to § 6511.

Failure to pay the tax to the collecting agent may result in the imposition of penalties, as well as interest.

DRAFTING INFORMATION

The principal author of this notice is Cynthia A. McGreevy of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice contact Ms. McGreevy at (202) 622-3130 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 10, 2004
JS-1850

Remarks of
Wayne A. Abernathy
Assistant Secretary of the Treasury for Financial Institutions
before the Outreach Meeting of the
Financial and Banking Information Infrastructure Committee
and the
Financial Services Sector Coordinating Council
Orlando, Florida
Relentless in Protecting the Symbols and Sinews of Freedom

The Mission: Preserving Freedom

So far as I can remember, the first bank I ever set foot in was the Deerfield Beach Bank, in the northeast corner of Broward County. While not much taller than the bank counter, that is where I opened up my passbook savings account. And that was where I would go to check for pennies as I began my first coin collection. As a young child, I learned that banks are about savings, the future, and personal service. I have never forgotten that lesson, and through the years I have tended to do my banking with the banks that remembered that lesson the best.

The other lesson I learned as a lad was a lesson of freedom, and how financial services companies facilitate my freedom. Today we are engaged in a new war, with a vicious enemy. This enemy is hidden. He strikes from behind, from disguise, from ambush. He knows no mercy, acknowledges no shame. His target is neither our land nor our wealth. His target is nothing less than our very way of life. It is who we are and how we live that the terrorist seeks to destroy.

Remember, and make no mistake: it is not precisely America--or the United States of America--that the terrorists are fighting. They target what America represents, what made America what it is. They target freedom. Were we to surrender our freedoms, that might be one way to stop the terrorism. They say that terrorists do not thrive in police states, that they prey upon free and open societies. But if we close our society and surrender our freedoms, then the terrorist wins, because it is our freedom--and what freedom does to people--what people do with freedom, free hearts, free minds--this is what the terrorist hates.

President Bush has given to us in this Administration our mission--a mission to be conducting working with the people of this nation--the mission is to vanquish terrorism without surrendering our freedom, to draw upon the power of our freedom to fight and defeat terrorism. The oft quoted and seldom read Alexis de Tocqueville saw a great genius in Americans to associate, to come together freely to achieve important goals. That is the task before us today.

The Symbols and Sinews

As we have been reminded yet again in recent days, pitiless people have their sights set on the symbols and sinews of freedom. Those symbols and sinews include the systems, the relationships, the arrangements, and the institutions that enable people to associate freely here in this nation and from here throughout the world. The haters of freedom despise free markets, free enterprise, and they are targeting the financial institutions that support those free markets.

Today I salute and congratulate you and your colleagues in the financial services industries, you who know that you are in the terrorists' sites, and yet are determined to go on with your important business, knowing that it is your business that helps millions of others all over the country go on with their business. We will not be cowed, we will not be intimidated, but instead we will respond to threats with renewed effort and determination.

We are assembled here today, as others have in other financial centers around the country, and as others will yet assemble elsewhere, to say that we will not let the terrorists, we will not let the enemies of freedom, we will not let them destroy or disrupt our financial commerce, we will not let them interfere with our ability to save, to invest, to borrow, to insure against life's dangers.

With planning, preparation, and prudence, we can deny the terrorists the prize they seek. They want to make you stop. They want to make you close up shop. They want to make you fear to innovate, to invest, to create new opportunities, new products, new jobs. I firmly believe that if we are prepared, we need not fear.

Good News

I am a good news man. I look for the good news, and I usually find it. There is a good news story here, several stories. First of all, our war against the terrorists continues to progress and bring successes. While the terrorists are plotting, they now know that they have to look over their shoulder, because we are coming after them. We are more relentless than they are. We are finding them, we are exposing their plots. In exposing their plots, we are increasing the chance of frustrating their plots.

Second, because of work done already, our financial systems are stronger and more resilient than ever before. Behind each financial system, each financial service, you are likely to find an alternative system or service, waiting to be called upon. Whether the challenge is a hurricane, a software foul up, or a terrorist attack, when it threatens there is an alternative, often several alternatives, ready for use.

Today, in New York, in northern New Jersey, in Washington the financial sector is at a higher level of alert, we are on watch, on our guard, and back up systems and programs are at the ready. But we are on our guard not just there, but here in Florida, too. The information recently revealed tells us for certain that terrorists are looking at our financial services companies, and we must be careful not to conclude that because we have exposed one plot that there is not another. We must not think that because we are not named in one exposed plot, that we are free from risk. We ask you to look at the exposed patterns and look at your efforts. Ask whether you are taking adequate precautions, are your back up arrangements in order? And look around you. Notice the unusual, the out of place, and share and compare. Today we will discuss some tools to help you do that.

The Essential, Obvious Things to Do

This morning I would like to share with you four principles that should guide our preparations. They should also guide us in our response to calamity, whether manmade calamities or the calamities of nature. I presented these principles to Congress last year, when I explained how well they had worked at the time of the Detroit to New York power black out of last summer.

I recently shared these with members of my family. I could tell that they were not impressed. When I asked them why, they told me in effect that these points were rather obvious. They had me there. I offer in defense the words of Calvin Coolidge, who once said,

> They criticize me for harping on the obvious. Perhaps some day I'll write *On the Importance of the Obvious*. If all the folks in the United States would do the few simple things they know they ought to do, most of our big problems would take care of themselves. (Calvin

Coolidge, quoted by Cal Thomas in, "Silent Cal Speaks: Why Calvin Coolidge Is the Model for Conservative Leadership Today," *The Heritage Lecture Series*, No.576, p.3)

These are the four principles. They are presented in order of importance, and I confess that they are obvious. I would add, though, that in times of stress and challenge, the obvious does not always seem so obvious. These points are even more important than they are obvious:

First, and most important, we must remember in all that we do to protect our financial infrastructure, that it is always about people. It is the people that make our financial institutions work, people that designed the systems, people that make them successful, people that innovate to keep them fresh and dynamic, and it is people whom they are designed to serve, people who rely upon financial services for so many aspects of their daily lives. Our first consideration in planning and action must be, how does it affect people.

Second, because it is about people, it is about confidence. Our financial institutions operate on confidence, but they also promote confidence. In fact, confidence is what our financial institutions must provide, confidence that financial transactions will be carried out, that checks will clear, that bills will be paid, that investments will be made, that insurance promises will be kept. The confidence provided by financial institutions and their services play a big part in helping to cope with the trauma of disaster. With good reason, earned by experience, the world places great confidence in American financial institutions. In our planning and in our action, what are we doing to promote confidence?

Third, essential to that confidence is open markets, financial institutions open for business, doing their business, allowing Americans everywhere to engage in their business, even during--especially during--times of stress. It is important for financial institutions and markets to continue to operate as close to business-as-usual as possible. During times of stress, investors need to price the effects of that stress on assets. The longer they are prevented from pricing the impact, the more anxiety builds and the worse the consequences will be when markets eventually re-open. What do we need to do, in planning and action, to keep our markets open?

The fourth guiding principle is responsibility. Each bank, every insurance company, every single financial institution has a responsibility to its customers. Every regulator has a responsibility to the financial institutions that it supervises. That responsibility applies both as we prepare for disruptions and as we weather them. In the event of a disorder in the payments system, for example, we want the payments systems experts to fix it. We do not want them to wait for guidance from Washington. Just fix it. The experts who are on the ground and in the field are the best to determine what steps should be taken to protect employees and customers. We will help where we can and where we need to, but we leave the responsibility with the financial institutions and the regulators that are closest to the problems to find the solutions. Initiative and ingenuity are the most powerful tools to deal with any disruption, and we must give full room for their exercise. All of us must shoulder our responsibility.

People, confidence, open markets, and responsibility are the four keys, the fundamental principles that guide us. They guide our preparations, and they guide our response. They were tested by that unexpected drill last summer when the lights went out from Detroit to New York, and they worked well. People did not lose money from their accounts, there was no panic, financial markets opened and operated, and there were no calls to Washington from financial leaders asking what to do. They have been tested often since, most recently this past week. Each test shows us better prepared, and outlines where more work needs to be done.

Time for Work

So, there is more work for all of us to do. Your presence and participation here today demonstrate your willingness to roll up your sleeves and do the work.

I was taught that the most important part of prayer is what you do after you get up off of your knees. If today's meetings are to have lasting effect, it will come from what you do when you leave these meetings. Work with your colleagues, consult, share best ideas. We are ready to lend a hand, to assist you in your efforts, all in keeping with the four obvious and absolutely essential principles I have outlined today.

A few weeks ago, I addressed a meeting of financial services leaders in Richmond, Virginia. I brought my youngest son with me that day. He is about the age when I walked into a bank for the first time. He reminds me, he and his generation remind us all, that it is the future, a future of freedom, free markets, free enterprise, free minds and free homes, that we are preserving, that we are building. There are people in the world who hate all of that, who would destroy it if they could, but we won't let them. As Americans have done in the past, we today will stop them. Thank you for letting me join with you in that effort.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 10, 2004
JS-1851

Treasury Assistant Secretary for Financial Institutions, Wayne A. Abernathy Leads Florida Roundtable to Discuss Financial Education with Local Leaders in Orlando

Treasury Assistant Secretary for Financial Institutions Wayne Abernathy today led a financial education roundtable, hosted by the InCharge Education Foundation in Orlando, Florida. Abernathy highlighted Treasury's financial education initiatives and the role of the new Financial Literacy and Education Commission established by Title V of the Fair and Accurate Credit Transactions Act. Abernathy and over 15 participants representing Orlando businesses, nonprofits, the academic community and local government also discussed how to improve financial education in Orlando and the country.

"Businesses, schools and local leaders play a key role in improving financial education in their communities. By continuing to work together and identifying best practices for financial education, communities can help people enjoy the benefits of acquiring good personal finance skills," said Abernathy. "By helping to coordinate this important effort, groups like the InCharge Education Foundation improve access to financial education."

The InCharge Education Foundation is a national non-profit organization that specializes in personal finance education and research. The organization promotes financial education through various programs including: Credit Compass, MindYourFinances.com and dinerohispano.com. It publishes the YOUNG MONEY and Military Money magazines, as well as produces the Mike Schiano radio program.

In addition to InCharge Education Foundation staff, over 15 representatives from the private, nonprofit, academic and local government sectors also participated in the forum. The following organizations participated at today's roundtable: Employer Services, Workforce Central Florida; Smith Barney; the University of Kentucky; Hispanic Business Initiative Fund of Greater Orlando; Virginia Tech; Florida Credit Union League - Central Florida Chapter; CCCS of Central Florida & the Florida Gulf Coast; InCharge Debt Solutions; Central Florida Educators' Federal Credit Union; Colonial Bank; Valencia Community College; Central Florida Educators' Federal Credit Union; UCF Federal Credit Union; Center for Economic Education, University of Central Florida; Instruction and Curriculum Services, Orange County Public Schools; and Junior Achievement of Central Florida.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, homeownership and retirement planning. The office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 10, 2004
JS-1852

Treasury Identifies Cuban-Controlled Shipping Entity as a SDN

The U.S. Department of the Treasury today took further action against Fidel Castro's oppressive regime by identifying Melfi Marine, a shipping company controlled by the Cuban government, as a Specially Designated National (SDN) of Cuba.

"With this step, we continue to restrict the Cuban government's access to capital by identifying and isolating companies controlled by Castro," said Juan Carlos Zarate, Treasury's Assistant Secretary for Terrorist Financing. "The Castro government uses money to enrich itself and perpetuate its totalitarian regime at the expense of the Cuban people."

Melfi Marine was incorporated in Panama in 1981 and is a wholly-owned subsidiary of Cimex, identified by the Treasury Department in February 2004 as a SDN of Cuba. Cimex is a holding company owned by the Castro regime. Melfi Marine provides container shipping service between Halifax, Nova Scotia, Canada and Havana, Cuba.

Persons subject to U.S. jurisdiction may not engage in any transactions with Melfi Marine unless authorized by Treasury's Office of Foreign Assets Control (OFAC), and all property of Melfi Marine that is in the possession of persons subject to U.S. jurisdiction is blocked.

Today's action comes on the heels of strengthened measures by the Bush Administration to keep hard currency and travel-related dollars out of Castro's coffers. Treasury's announcement today is in furtherance of President Bush's October 2003 initiative intended to hasten the arrival of a new, free and democratic Cuba by strengthening enforcement of U.S. laws prohibiting travel-related transactions with the island.

With today's announcement, the Treasury Department has now taken action against 12 Castro-controlled entities since President Bush's October 2003 statement.

ENTITY

Melfi Marine Corporation S.A.

a.k.a..: **Melfi Marine, S.A.**

Addresses:

- Calle Oficios No. 410 e/Luz y Acosta, La Habana Vieja, Habana, Cuba;
- Anillo del Puerto e/Pote y Linea del Ferrocarril, La Habana Vieja, Habana, Cuba;
- Oficios 104, Havana Vieja, Havana, Cuba;
- Oficina 7, Edificio Senorial, Calle 50 Apartado 31, Panama City, 5, Panama.

For more information on previous identifications of entities controlled by the Cuban government, please visit the links below:

- www.treas.gov/press/releases/js1161.htm
- www.treas.gov/press/releases/js1240.htm

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 11, 2004
js-1853

Secretary Snow Visits Florida This Week

U.S. Treasury Secretary John W. Snow will visit Southeastern Florida on Friday, August 13 to meet with local business leaders and discuss the President's efforts to strengthen the economy and create jobs.

"As a result of the President's economic leadership, we have overcome a recession and seen 11 straight months of job creation, totaling nearly 1.5 million new U.S. jobs since August 2003," said Secretary Snow. "So far this year, Florida has gained nearly 82,000 new jobs and the President's tax reform policies have ensured that more than 6.1 million Florida taxpayers will have lower income tax bills in 2004."

During this trip to Florida, expect Secretary Snow to also discuss the Administration's efforts to control health care costs, reduce frivolous lawsuits and ensure that America has reliable and affordable sources of energy.

Recent indicators show that President Bush's economic policies continue to move the economy forward. According to the Labor Department, the national unemployment rate declined to 5.5% in July – down 0.8 percentage point from a peak of 6.3% in June 2003 and the lowest rate since October 2001. At 5.5%, the unemployment rate is below the average of the 1970s, 1980s, and 1990s. Employment over the last year was up in 46 of the 50 states and the unemployment rate was down in all regions and in 47 of the 50 states.

The following events are open to the media, which must present media credentials or photo ID:

Friday, August 13

Roundtable Discussion with Local Business Leaders
Greater Boca Raton Chamber of Commerce and South Florida Business Alliance
9:30 am EDT
Nabi Biopharmaceuticals
5800 Park of Commerce Blvd., N.W.
Boca Raton, FL
** Media should arrive by 8:45 am

Tour of Nabi Biopharmaceuticals
10:30 am EDT
Nabi Biopharmaceuticals
5800 Park of Commerce Blvd., N.W.
Boca Raton, FL
Press Conference – Treasury Secretary Snow and U.S. Congressman E. Clay Shaw
11:30 am EDT
Nabi Biopharmaceuticals
5800 Park of Commerce Blvd., N.W.
Boca Raton, FL

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 11, 2004
js-1854

Treasury Provides Guidance on Classification of Business Entities Organized In Multiple Jurisdictions

Today the Treasury Department issued temporary and proposed regulations regarding the proper classification for federal tax purposes of business entities organized in multiple jurisdictions.

In general, the status of a business entity for tax purposes – for example, as a corporation or as some other type of entity such as a partnership – depends on its form of organization. Under existing final regulations, entities that take certain forms in their country of organization generally are treated as corporations. Treasury and the IRS are aware, however, that some taxpayers have taken the position that the fact that an entity takes one of these corporate forms of organization may be disregarded if the entity takes a different form in another jurisdiction. This position is erroneous because all aspects of an entity's organization must be taken into account when determining its status. Accordingly, the temporary and proposed regulations make clear that, when an entity is ganized in more than one jurisdiction, it is treated as a corporation for tε)urposes if it takes a corporate form in any jurisdiction.

Generally, for tax purposes, a business entity is considered to be a domestic entity if it is organized in the United States, and is considered to be a foreign entity only if it is not organized in the United States. Accordingly, the temporary and proposed regulations make clear that, when a business entity is organized both in the United States and in a foreign jurisdiction, it is treated as a domestic entity for federal tax purposes.

The texts of the temporary and proposed regulations are attached.

REPORTS

- Temporary Regulations
- Proposed Regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[TD 9153]

RIN 1545-BD43

Clarification of Definitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations providing clarification of the definitions of a corporation and a domestic entity in circumstances where the business entity is considered to be created or organized in more than one jurisdiction. These regulations will affect business entities that are created or organized under the laws of more than one jurisdiction. The final regulations consist of technical revisions to reflect the issuance of the temporary regulations and to correct a cross-reference in §301.7701-3. The text of the 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 Date: These regulations are effective August 12, 2004.

Applicability Dates: For the dates of applicability of these regulations, see §301.7701-2T(f) and §301.7701-5T(c).

FOR FURTHER INFORMATION CONTACT: Thomas Beem, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Several jurisdictions have recently enacted provisions (generally referred to as either continuance or domestication statutes) that make it possible for a business entity to be treated as created or organized under the laws of more than one jurisdiction at the same time (a dually chartered entity). A dually chartered entity and the interest holders in the entity must determine for Federal tax purposes (1) the entity's classification (e.g., corporation or partnership) and (2) whether the entity is foreign or domestic. The regulations contained in this document are intended to clarify the rules for these determinations.

Section 7701(a)(3) of the Internal Revenue Code of 1986 (Code) provides that the term corporation includes associations, joint stock companies, and insurance companies. The definition of a corporation under the tax statutes has not changed since the Revenue Act of 1918, Public Law 65-254 (40 Stat. 1057, section 1). Final regulations (TD 8697) providing rules for the classification of business entities were published in the Federal Register on December 18, 1996 (61 FR 66584 (1996)). Those entity classification rules identify certain entities that are always treated as corporations and are not eligible to elect their entity classification.

Section 7701(a)(4) of the Code provides that the term domestic when applied to a corporation or partnership means "created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations." Section 7701(a)(5) of the Code provides that the term foreign when applied to a corporation or partnership means a "corporation or partnership that is not domestic." This definition is significantly different than the definition of foreign entity that preceded it. The Revenue Act of 1918 used the term foreign to mean a corporation or partnership "created or organized outside the United States." Thus, under that definition, a dually chartered entity that was organized in the United States and in a foreign jurisdiction would have met the definitions of both a domestic entity and a foreign entity, creating uncertainty as to

the entity's status. The Revenue Act of 1924, Public Law 68-176 (43 Stat. 253) eliminated that potential for uncertainty by providing the definition of a foreign entity that is currently reflected in section 7701(a)(5). This definition of a foreign entity as "a corporation or partnership that is not domestic" makes it impossible for an entity to meet the definitions of both a domestic entity and a foreign entity for Federal tax purposes at the same time. As a result, a dually chartered entity that is organized both in the United States and in a foreign jurisdiction is a domestic entity.

Final regulations providing further guidance on the definitions of domestic and foreign business entities were published in the Federal Register on November 17, 1960 (25 FR 10928 (1960)).

Explanation of Provisions

Under the existing rules, the characterization of a business entity for Federal tax purposes is established in two separate and independent steps. The first involves a determination of whether the entity is a corporation or a non-corporate entity (e.g., a partnership). The second involves a determination of whether the entity is foreign or domestic.

The determination of whether a business entity is classified as a corporation is made by applying the definition in §301.7701-2(b). If the entity is not a corporation under that definition, then it is a partnership if it has more than one owner and it is a disregarded entity if it has only a single owner. The temporary regulations in this document clarify that this same definition applies to dually chartered entities. Thus, to determine whether a dually chartered entity is a corporation, it must first be determined if the entity's organization in any of the jurisdictions in which it is organized would cause it to be treated as a corporation under the rules of §301.7701-2(b). If the entity would be treated as a corporation as a result of its formation in any of the jurisdictions in which it is organized, it is treated as a corporation for Federal tax purposes even though its organization in the other jurisdiction or jurisdictions would not have caused it to be treated as a corporation.

Once the classification of a business entity has been determined, a determination will generally need to be made regarding whether it is a domestic or foreign entity. It is a domestic entity if it is created or organized in the United States or under the laws of the United States or of any state. It is a foreign entity only if it is not domestic. The temporary regulations in this document revise §301.7701-5 to clarify that a dually chartered entity is domestic if it is organized as any form of entity in the United States, regardless of how it is organized in any foreign jurisdiction. An entity that is classified as a corporation because of its form of organization in a foreign country is considered a domestic corporation if it is also organized as some form of entity in the United States, regardless of what form the entity takes in the United States (e.g., corporation, limited liability company, or partnership).

These temporary regulations also remove from §301.7701-5 the definitions of resident foreign corporation, nonresident foreign corporation, resident partnership and nonresident partnership because these terms have become obsolete due to statutory changes since the final regulations were published in 1960.

These regulations clarify current law and do not change the outcome that would result under a proper application of the existing rules as they apply to dually chartered entities. For example, the temporary regulations are consistent with the result in Rev. Rul. 88-25 (1988-1 C.B. 116). These regulations are also not intended to affect the result under existing rules regarding whether an organization is a separate entity for Federal tax purposes (e.g., whether, in a particular case, two sets of organizational documents constitute different facets of a single entity or the foundations of two separate entities). In addition, if a business entity undertakes a continuance, domestication, or other transaction that, upon application of these rules, changes its entity classification or changes its foreign or domestic status, the tax effects of that transaction are determined under the regular tax principles that apply to such changes. Finally, the regulations contained in this document do not determine an entity's place of residence for the purpose of applying the provisions of a tax treaty.

Section 7701(a)(4) of the Code provides regulatory authority to define a domestic partnership other than based on where the partnership is created or organized. The Treasury and the IRS are continuing to explore whether, and under what circumstances, a different definition may be appropriate. If any change to the definition of a domestic partnership were to be proposed, it would apply only to partnerships created or organized after the issuance of regulations or other guidance substantially describing the change in definition.

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 notice of proposed rulemaking published in the proposed rules section in this issue of the **Federal Register**. Pursuant to section 7806(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

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

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and Recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301 -- PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. In §301.7701-1, paragraph (d) is revised to read as follows:

§301.7701-1 Classification of organizations for federal tax purposes.

* * * * *

(d) Domestic and foreign business entities. [Reserved]. For further guidance, see §301.7701-1T.

* * * * *

Par 3. Section 301.7701-1T is added to read as follows:

§301.7701-1T Classification of organizations for federal tax purposes (temporary).

(a) through (c) [Reserved]. For further guidance, see §301.7701-1(a) through (c).

(d) Domestic and foreign entities. See §301.7701-5T for the rules that determine whether a business entity is domestic or foreign.

(e) through (f) [Reserved].

Par. 4. In §301.7701-2, paragraph (b)(9) is added to read as follows:

§301.7701-2 Business entities; definitions.

* * * * *

(b) * * *

(9) [Reserved]. For further guidance, see §301.7701-2T(b)(9).

* * * * *

Par. 5. Section 301.7701-2T is added to read as follows:

§301.7701-2T Business entities; definitions (temporary).

(a) through (b)(8) [Reserved] For further guidance, see §301.7701-2 (a) through (b)(8).

(b)(9) Entities with multiple charters. (i) An entity created or organized under the laws of more than one jurisdiction if the rules of this section would treat it as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized. (The

determination of a business entity's classification is made independently of the determination whether the entity is domestic or foreign. See §301.7701-5T for the rules that determine whether a business entity is domestic or foreign.)

(ii) Examples. The following examples illustrate the rule of this paragraph (b)(9):

Example 1. (i) Facts. X is an entity with a single owner organized under the laws of Country A as an entity that is specifically mentioned in paragraph (b)(8)(i) of this section. Under the rules of this section, such an entity generally is a corporation for Federal tax purposes. Several years after its formation, X files a certificate of domestication in State B as a limited liability company (LLC). Under the laws of State B, X is considered to be created or organized in State B as a LLC upon the filing of the certificate of domestication and is therefore subject to the laws of State B. Under the rules of this section and §301.7701-3, a LLC with a single owner organized only in State B is disregarded as an entity separate from its owner for Federal tax purposes (absent an election to be treated as an association). Neither Country A nor State B law requires X to terminate its charter in Country A as a result of the domestication, and in fact X does not terminate its charter in Country A. Consequently, X is now organized in more than one jurisdiction.

(ii) Result. X remains organized under the laws of Country A as an entity that is specifically mentioned in §301.7701-2(b)(8)(i), and as such, it is an entity that generally is treated as a corporation under the rules of this section. Therefore, X is a corporation for Federal tax purposes because the rules of this section would treat X as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

Example 2. (i) Facts. Y is an entity that is incorporated under the laws of State A and that has two shareholders. Under the rules of this section, an entity incorporated under the laws of State A is a corporation for Federal tax purposes. Several years after its formation, Y files a certificate of continuance in Country B as an unlimited company. Under the laws of Country B, upon filing a certificate of continuance, Y is treated as organized in Country B. Under the rules of this section and §301.7701-3, an unlimited company organized only in Country B that has more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). Neither State A nor Country B law requires Y to terminate its charter in State A as a result of the continuance, and in fact Y does not terminate its charter in State A. Consequently, Y is now organized in more than one jurisdiction.

(ii) Result. Y remains organized in State A as a corporation, an entity that is treated as a corporation under the rules of this section. Therefore, Y is a corporation for Federal tax purposes because the rules of this section would treat Y as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

Example 3. (i) Facts. Z is an entity that has more than one owner and that is recognized under the laws of Country A as an unlimited company organized in Country A. Under the rules of this section and §301.7701-3, an unlimited company organized only in Country A with more than one owner is treated as a partnership for Federal tax purposes (absent an election to be treated as an association). At the time Z was formed, it was also organized as a public limited company under the laws of Country B. Under the rules of this section, a public limited company organized only in Country B generally is treated as a corporation for Federal tax purposes.

(ii) Result. Z is organized in Country B as a public limited company, an entity that generally is treated as a corporation under the rules of this section. Therefore, Z is a corporation for Federal tax purposes because the rules of this section would treat Z as a corporation as a result of its formation in one of the jurisdictions in which it is created or organized.

(c) through (e) [Reserved]. For further guidance, see §301.7701-2(c) through (e).

(f) Special effective date. The rules of this section apply as of August 12, 2004, to all business entities existing on or after that date.

Par. 6. In §301.7701-3, the last sentence of paragraph (b)(3)(i) is revised to read as follows:

§301.7701-3 Classification of certain business entities.

* * * * *

(b) * * *

(3) * * * (i) * * *For special rules regarding the classification of such entities prior to the effective date of this section, see paragraph (h)(2) of this section.

* * * * *

Par. 7. Section 301.7701-5 is revised to read as follows:

§301.7701-5 Domestic and foreign business entities. [Reserved]. For further guidance, see §301.7701-5T.

Par. 8. Section 301.7701-5T is added to read as follows:

§301.7701-5T Domestic and foreign business entities (temporary)

(a) Domestic and foreign entities. A business entity (including an entity that is disregarded as separate from its owner) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or of any State. Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. A business entity (including an entity that is disregarded as separate from its owner) is foreign if it is not domestic. (The determination of whether an entity is domestic is made independently of the determination of its

classification for Federal tax purposes. See §§301.7701-2, 301.7701-2T, and 301.7701-3 for the rules governing the classification of entities.)

(b) Examples. The following examples illustrate the rules of this section:

Example 1. (i) Facts. Y is an entity that is created or organized under the laws of Country A as a public limited company. It is also an entity that is organized as a limited liability company (LLC) under the laws of State B. Y has been classified as a corporation for Federal tax purposes under the rules of §§301.7701-2, 301.7701-2T, and 301.7701-3.

(ii) Result. Y is a domestic corporation because it is an entity that is classified as a corporation and it is organized as an entity under the laws of State B.

Example 2. (i) Facts. P is an entity with more than one owner organized under the laws of Country A as an unlimited company. It is also an entity that is organized as a general partnership under the laws of State B. P has been classified as a partnership for Federal tax purposes under the rules of §§301.7701-2, 301.7701-2T, and 301.7701-3.

(ii) Result. P is a domestic partnership because it is an entity that is classified as a partnership and it is organized as an entity under the laws of State B.

(c) Effective date. The rules of this section apply as of August 12, 2004,

to all business entities existing on or after that date.

Mark E. Matthews
Deputy Commissioner for Services and Enforcement.

Approved: July 21, 2004

Gregory Jenner
Acting Assistant Secretary of the Treasury.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[REG-124872-04]

RIN 1545-BD37

Clarification of Definitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: This issue of the **Federal Register** contains temporary regulations that provide clarification of the definitions of a corporation and a domestic entity in circumstances where the business entity is considered to be created or organized in more than one jurisdiction. These regulations will affect business entities that are created or organized under the laws of more than one jurisdiction. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and must be received by November 10, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 3, 2004 must be received by October 15, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-124872-04), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday (excluding Federal holidays) between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-124872-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC or sent electronically, via either the IRS internet site at www.irs.gov/regs or the Federal eRulemaking Portal at

www.regulations.gov (IRS and REG-124872-04). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Thomas Beem, (202) 622-3860; concerning submissions of comments or the public hearing, Sonya Cruse, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the **Federal Register** amend 26 CFR part 301 relating to section 7701 of the Internal Revenue Code of 1986 (Code). The temporary regulations provide guidance as to the definitions of a corporation and of domestic and foreign entities in circumstances in which an entity is created or organized under the laws of more than one jurisdiction (a dually chartered entity). The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains both 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 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 7806(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are 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 November 3, 2004 at 10:00 a.m. in the Auditorium of the Internal Revenue building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area earlier than 30 minutes prior to the start of the hearing. 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 this hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time devoted to each topic (signed original and eight (8) copies) by October 15, 2004. A period of ten minutes will be allotted to each person for making comments. An agenda showing the scheduling of 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.

Proposed Effective Date

The regulations proposed in this document would apply on August 12, 2004, to all business entities existing on or after that date.

Drafting Information

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

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and Recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301 -- PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read, in part, as follows:

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

Par. 2. In §301.7701-1, paragraph (d) is revised to read as follows:

§301.7701-1 Classification of organizations for federal tax purposes.

* * * * *

(d) [The text of the proposed amendment revising §301.7701-1(d) is the same as the text of §301.7701-1T(d) published elsewhere in this issue of the **Federal Register**.]

* * * * *

Par. 3. In §301.7701-2 paragraph (b)(9) is added to read as follows:

§301.7701-2 Business entities; definitions.

* * * * *

(b) * * *

(9) [The text of the proposed amendment adding §301.7701-2(b)(9) is the same as the text of §301.7701-2T(b)(9) published elsewhere in this issue of the **Federal Register**.]

* * * * *

Par. 4. Section 301.7701-5 is revised to read as follows:

§301.7701-5 Domestic and foreign business entities.

[The text of the proposed amendment revising §301.7701-5 is the same as the text of

§301.7701-5T published elsewhere in this issue of the **Federal Register**.]

Mark E. Matthews
Deputy Commissioner for Services and Enforcement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 12, 2004
JS-1855

Treasury and IRS Issue Regulations on Lifo Recapture for S Corporations that Own Partnership Interests

The Treasury Department and the Internal Revenue Service today issued proposed regulations providing that a corporation that elects to become an S corporation must recapture its portion of the LIFO inventory benefit of a partnership in which the electing corporation holds a partnership interest.

Under the LIFO recapture rules, a C corporation that inventories goods under the LIFO (last-in, first-out) method of accounting and that elects to be taxed as an S corporation must include in its gross income the LIFO recapture amount. The LIFO recapture amount is the amount of income that the corporation has deferred by using the LIFO method rather than the FIFO method. The proposed regulations would require a corporation that converts to S status to take into account a LIFO recapture amount with respect to its share of LIFO inventory held in a partnership in which the corporation holds a partnership interest.

REPORTS

- The text of the proposed regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-149524-03]

RIN 1545-BC66

LIFO Recapture Under Section 1363(d)

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations regarding LIFO recapture by corporations converting from C corporations to S corporations. The purpose of the proposed regulations is to provide guidance on the LIFO recapture requirement when the corporation holds inventory accounted for under the last-in, first-out (LIFO) method (LIFO inventory) indirectly through a partnership. The proposed regulations affect C corporations that own interests in partnerships holding LIFO inventory and that elect to be taxed as S corporations or that transfer such partnership interests to S corporations in nonrecognition transactions. The proposed regulations also affect S corporations receiving such partnership interests from C corporations in nonrecognition transactions.

DATES: Written or electronic comments must be received by November 12, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Wednesday, December 8, 2004 must be received by Wednesday, November 17, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-149524-03), room 5203,

Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-149524-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC or submitted electronically via the IRS Internet site at: http://www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-149524-03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Pietro Canestrelli, 202-622-3060, or Martin Schäffer, 202-622-3070; concerning submissions, Robin Jones, 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 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). 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 October 12, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper

performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (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 can be minimized, including through the application of automated collection techniques or other forms of information technology; and

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

The collection of information in this proposed regulation is in §1.1363-2(e)(3). This information is required to inform the IRS of partnerships electing to increase the basis of inventory to reflect any amount included in a partner's income under section 1363(d). Thus, the collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The burden for the collection of information in §1.1363-2(e)(3) is reflected on Form 1065, "Partnership Return of Income".

The estimated burden for the collection of information in §1.1363-2(e)(3) is as follows:

Estimated total annual reporting burden: 200 hours.

The estimated annual burden per respondent varies from 1 to 3 hours, depending on individual circumstances, with an estimated average of 2 hours.

Estimated number of respondents: 100.

Estimated annual frequency of responses: On occasion.

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 contains proposed amendments to 26 CFR Part 1 under section 1363(d) of the Internal Revenue Code (Code). Section 1363(d)(1) provides that a C corporation that owns LIFO inventory and that elects under section 1362(a) to be taxed as an S corporation must include in its gross income for its final tax year as a C corporation the LIFO recapture amount. Under section 1363(d)(3), the LIFO recapture amount is the excess of the inventory amount of the inventory using the first-in, first-out (FIFO) method (the FIFO value) over the inventory amount of the inventory using the LIFO method (the LIFO value) at the close of the corporation's final tax year as a C corporation (essentially, the

amount of income the corporation has deferred by using the LIFO method rather than the FIFO method).

Final regulations (TD 8567) under section 1363(d) were published in the **Federal Register** on October 7, 1994 (59 FR 51105) to describe the recapture of LIFO benefits when a C corporation that owns LIFO inventory elects to become an S corporation or transfers LIFO inventory to an S corporation in a nonrecognition transaction. The final regulations do not explicitly address the indirect ownership of inventory through a partnership. These proposed regulations provide guidance for situations in which a C corporation that owns LIFO inventory through a partnership (or through tiered partnerships) converts to an S corporation or transfers its partnership interest to an S corporation in a nonrecognition transaction.

Section 1374, modified as part of the repeal of the General Utilities doctrine, see General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), imposes a corporate level tax on certain income or gain recognized by an S corporation to the extent the income or gain is attributable to appreciation that occurred while the assets were held by a C corporation. Specifically, section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation. The tax is imposed only during the 10-year period beginning on the first day the corporation is an S corporation. In addition, section 1374 imposes a corporate level tax on an S corporation's net recognized built-in gain attributable to assets that the S corporation acquires if the S corporation's bases in

such assets are determined (in whole or in part) by reference to the bases of such assets (or any other property) in the hands of a C corporation. This tax is imposed only during the 10-year period beginning on the date that the S corporation acquires the assets.

In Announcement 86-128 (1986-51 I.R.B. 22), the IRS stated that, for purposes of section 1374(d)(2)(A), the inventory method used by a taxpayer for tax purposes (FIFO, LIFO, etc.) shall be used in determining whether goods disposed of following a conversion from C corporation to S corporation status were held by the corporation at the time of conversion. After the issuance of this announcement, Congress became concerned that taxpayers owning LIFO inventory might avoid the built-in gain rules of section 1374. Congress believed that taxpayers owning LIFO inventory, who have enjoyed the deferral benefits of the LIFO method during their status as a C corporation, should not be treated more favorably than their FIFO counterparts. To eliminate this potential disparity in treatment, Congress enacted section 1363(d) in 1987, requiring a taxpayer owning LIFO inventory to recapture the benefits of using the LIFO method. H.R. Rep. No. 100-391 (Parts 1 and 2), 1098 (1987).

In Coggin Automotive Corp. v. Commissioner, 292 F.3d 1326 (11th Cir. 2002), rev'g 115 T.C. 349 (2000), a holding company owned majority interests in several subsidiaries that operated automobile dealerships owning LIFO inventory. As part of a restructuring, each subsidiary contributed its assets (including its LIFO inventory) to a different partnership. The subsidiaries were then merged into the holding company, which elected to be taxed as an S corporation. The court of appeals held that the holding company's S

corporation election did not trigger LIFO recapture under section 1363(d) because it was the partnerships in which the holding company held interests, and not the holding company itself, that used the LIFO method.

Section 337(d)(1) authorizes the Secretary to prescribe regulations to prevent the circumvention of the purposes of the repeal of the General Utilities doctrine through the use of any provision of law or regulations. The Treasury Department and the IRS believe that these proposed regulations are necessary to implement General Utilities repeal. Congress enacted section 1363(d) because the use of the LIFO method by a C corporation that converts to S corporation status creates the potential for the permanent avoidance of corporate level tax on the built-in gain reflected in the LIFO reserve. This avoidance possibility is present regardless of whether the converting corporation owns inventory directly or indirectly through a partnership or tiered partnerships. Accordingly, the Treasury Department and the IRS believe it is appropriate to require the recapture of a converting corporation's share of the LIFO reserves of partnerships in which it participates. Such an approach is consistent with the regulations under section 1374, which generally adopt a lookthrough approach to partnerships.

Explanation of Provisions

The proposed regulations provide that a C corporation that holds an interest in a partnership owning LIFO inventory must include the lookthrough LIFO recapture amount in its gross income where the corporation either elects to be an S corporation or transfers its interest in the partnership to an S corporation in a nonrecognition transaction. The

proposed regulations define the lookthrough LIFO recapture amount as the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704-3, if the partnership sold all of its LIFO inventory for the FIFO value. A corporate partner's lookthrough LIFO recapture amount must be determined, in general, as of the day before the effective date of the S corporation election or, if the recapture event is a transfer of a partnership interest to an S corporation, the date of the transfer (the recapture date). The proposed regulations provide that, if a partnership is not otherwise required to determine inventory values on the recapture date, the lookthrough LIFO recapture amount may be determined based on inventory values of the partnership's opening inventory for the year that includes the recapture date.

The proposed regulations provide that a corporation owning LIFO inventory through a partnership must increase its basis in its partnership interest by the lookthrough LIFO recapture amount. The proposed regulations also allow the partnership through which the LIFO inventory is owned to adjust the basis of partnership inventory (or lookthrough partnership interests held by that partnership) to account for LIFO recapture. This adjustment to basis is to be patterned in manner and effect after the adjustment in section 743(b). Thus, the basis adjustment constitutes an adjustment to the basis of the LIFO inventory (or lookthrough partnership interests held by that partnership) with respect to the corporate partner only; no adjustment is made to the partnership's common basis. The IRS and the Treasury Department request comments on whether the partnership should be required, in some or all circumstances, to increase the basis of partnership assets by the

lookthrough LIFO recapture amount attributable to those assets.

Under §1.1374-4(i)(1), an S corporation's distributive share of partnership items is not taken into account in determining the S corporation's share of net recognized built-in gain or loss if the S corporation's partnership interest represents less than 10 percent of the partnership capital and profits and has a fair market value of less than $100,000. This exception reduces the burden on the S corporation and the partnership of tracking built-in gain assets that are relatively small in amount.

The burden of looking through a partnership interest under section 1374 is greater than the burden of looking through a partnership interest under section 1363(d). Under section 1374, partnership assets must be tracked for a 10-year period. No such tracking problem exists under section 1363 because recapture generally occurs on the date of the S election. Accordingly, the proposed regulations do not contain an exception for partnership interests that are smaller than a specified threshold.

Proposed Effective Date

These regulations are proposed to apply to S elections and transfers made on or after August 13, 2004. No inference is intended as to the tax consequences of S elections and transfers made before the effective date of these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 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. This certification is based upon the fact that few corporations engage in the type of transactions that are subject to these regulations (the conversion from C corporation to S corporation status while holding an interest in a partnership that owns LIFO inventory or the transfer of an interest in such a partnership by a C corporation to an S corporation in a nonrecognition transaction). Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, 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 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 Wednesday, December 8, 2004 beginning at 10:00 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information

about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Wednesday, November 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 authors of these regulations are Martin Schäffer and Pietro Canestrelli, Office of Associate Chief Counsel (Passthroughs and Special Industries). 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.

Proposed Amendments to the Regulations

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

PART 1--INCOME TAXES

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

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

Section 1.1363-2 also issued under 26 U.S.C. 337(d). * * *

Par. 2. Section 1.1363-2 is amended by:

1. Redesignating paragraphs (b), (c), and (d) as paragraphs (d), (e), and (g), respectively.

2. Adding paragraphs (b), (c), (f), and (g)(3).

3. Revising newly designated paragraphs (d) and (e).

The revisions and additions read as follows:

' 1.1363-2 Recapture of LIFO benefits.

* * * * *

(b) LIFO inventory held indirectly through partnership. A C corporation must include the lookthrough LIFO recapture amount (as defined in paragraph (c)(2) of this section) in its gross income--

(1) In its last taxable year as a C corporation if, on the last day of the corporation's last taxable year before its S corporation election becomes effective, the corporation held a lookthrough partnership interest (as defined in paragraph (c)(1) of this section); or

(2) In the year of transfer by the C corporation to an S corporation of a lookthrough partnership interest if the corporation transferred its lookthrough partnership interest to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred interest constitutes transferred basis property (within the meaning of section 7701(a)(43)).

(c) Definitions--(1) Lookthrough partnership interest. A partnership interest is a lookthrough partnership interest if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the last-in, first-out (LIFO) method (LIFO inventory).

(2) Lookthrough LIFO recapture amount. For purposes of this section, a corporation's lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704-3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the first-in, first-out method of accounting authorized by section 471. The lookthrough LIFO recapture amount generally shall be determined as of the end of the recapture date. However, if the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, the partnership may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year that includes the recapture date. For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes inventory distributed by the partnership to a partner on or before the recapture date.

(3) Recapture date. In the case of a transaction described in paragraph (b)(1) of this section, the recapture date is the day before the effective date of the S corporation

election. In the case of a transaction described in paragraph (b)(2) of this section, the recapture date is the date of the transfer of the partnership interest to the S corporation (but only the portion of that date that precedes the transfer).

(d) Payment of tax. Any increase in tax caused by including the LIFO recapture amount or the lookthrough LIFO recapture amount in the gross income of the C corporation is payable in four equal installments. The C corporation must pay the first installment of this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corporation if paragraph (a)(1) or (b)(1) of this section applies, or for the taxable year of the transfer if paragraph (a)(2) or (b)(2) of this section applies. The three succeeding installments must be paid--

(1) For a transaction described in paragraph (a)(1) or (b)(1) of this section, by the corporation that made the election under section 1362(a) to be an S corporation, on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and

(2) For a transaction described in paragraph (a)(2) or (b)(2) of this section, by the transferee S corporation on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.

(e) Basis adjustments--(1) General rule. Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under paragraph (a) of this section.

(2) LIFO inventory owned through a partnership--(i) Basis of corporation's

partnership interest. Appropriate adjustments to the basis of the corporation's lookthrough partnership interest are to be made to reflect any amount included in income under paragraph (b) of this section.

(ii) Basis of partnership assets. A partnership directly holding LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that LIFO inventory. In addition, a partnership that holds, through another partnership, LIFO inventory that is taken into account under paragraph (b) may elect to adjust the basis of that partnership interest. Any adjustment under this paragraph (e)(2) to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. Likewise, any adjustment under this paragraph (e)(2) to the basis of a lookthrough partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to the interest. A basis adjustment under this paragraph (e)(2) is treated in the same manner and has the same effect as an adjustment to the basis of partnership property under section 743(b). See §1.743-1(j).

(3) Election. A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corporation election or transfer described in paragraph (b) of this section. This statement shall state that the partnership is electing under §1.1363-2(e)(3) and must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax under paragraph (d) of this section and of the partnership, as well as the amount of the adjustment and the portion of the adjustment that is attributable to each pool of inventory or lookthrough partnership interest that is held by the partnership.

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

Example 1. (i) G is a C corporation with a taxable year ending on June 30. GH is a partnership with a calendar year taxable year. G has a 20 percent interest in GH. The remaining 80 percent interest is owned by an individual. On April 25, 2005, G contributed inventory that is LIFO inventory to GH, increasing G's interest in the partnership to 50 percent. GH holds no other LIFO inventory. G elects to be an S corporation effective July 1, 2005. The recapture date is June 30, 2005 under paragraph (c)(3) of this section. GH determines that the FIFO and LIFO values of the opening inventory for GH's 2005 taxable year, including the inventory contributed by G, are $200 and $120, respectively.

(ii) Under paragraph (c)(1) of this section, GH is not required to determine the FIFO and LIFO values of the inventory on the recapture date. Instead, GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. For this purpose, under paragraph (c)(2) of this section, the opening inventory includes the inventory contributed by G. The amount by which the FIFO value ($200) exceeds the LIFO value ($120) in GH's opening inventory is $80. Thus, if GH sold all of its LIFO inventory for $200, it would recognize $80 of income. G's lookthrough LIFO recapture amount is $80, the amount of income that would be allocated to G, taking into account section 704(c) and §1.704-3, if GH sold all of its LIFO inventory for the FIFO value. Under paragraph (b)(1) of this section, G must include $80 in income in its taxable year ending on June 30, 2005. Under paragraph (e)(2) of this section, G must increase its basis in its interest in GH by $80.

Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, GH may elect to increase the basis (with respect to G only) of its LIFO inventory by $80.

Example 2. (i) J is a C corporation with a calendar year taxable year. JK is a partnership with a calendar year taxable year. J has a 30 percent interest in the partnership. JK owns LIFO inventory that is not section 704(c) property. J elects to be an S corporation effective January 1, 2005. The recapture date is December 31, 2004 under paragraph (c)(3) of this section. JK determines that the FIFO and LIFO values of the inventory on December 31, 2004 are $240 and $140, respectively.

(ii) The amount by which the FIFO value ($240) exceeds the LIFO value ($140) on the recapture date is $100. Thus, if JK sold all of its LIFO inventory for $240, it would recognize $100 of income. J's lookthrough LIFO recapture amount is $30, the amount of income that would be allocated to J if JK sold all of its LIFO inventory for the FIFO value (30 percent of $100). Under paragraph (b)(1) of this section, J must include $30 in income in its taxable year ending on December 31, 2004. Under paragraph (e)(2) of this section, J must increase its basis in its interest in JK by $30. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, JK may elect to increase the basis (with respect to J only) of its inventory by $30.

(g) Effective dates. * * *

(3) The provisions of paragraphs (b), (c), (e)(2), (e)(3), and (f) of this section apply to S elections and transfers made on or after August 13, 2004.

Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 13, 2004
JS-1856

The Honorable John W. Snow
Prepared Remarks to the Greater Boca Raton Chamber of Commerce
and the South Florida Business Alliance
August 13, 2004
Boca Raton, FL

Thank you so much for having me here today; it's great to be in Boca Raton and it's always a privilege to meet with the people who are creating jobs for their communities.

It's also a pleasure to see Congressman Clay Shaw here. He does a terrific job representing this district, and I certainly enjoy working with him on keeping your taxes as low as we can.

The economy here in Florida is doing very well, and I want to commend the business leaders here today for their role in Florida's success. You've created almost 82,000 jobs for Floridians so far this year, and that's terrific news for Florida families.

Growth among companies like yours is benefiting our economy on a national level as well. Although the President would like to see even stronger job growth, the good news is that jobs have been added to the national payrolls for 11 months in a row.

I anticipate that growth will continue on a national level, with states like Florida leading the way.

The President and I want all job-seekers to be rewarded with paychecks, and we know that the reward cannot come soon enough for them and their families. Even though lots of new jobs have been created in the last year, we're not satisfied.

The underlying fundamentals of our economy are very strong. We've seen that tax cuts work and that job creation does follow economic growth. I'm optimistic. An analyst at Prudential had it right this week when he said that you could fit the number of economists who think the economy is going south in a phone booth!

But beyond that academic, economic analysis, there is something else that is standing out to me. Everywhere I travel, I meet with small-business owners who drive our economy. And everywhere I go, they tell me that they are using their tax savings to grow their business and hire new employees; they know that the president's tax cuts have made all the difference in the world to them, putting oxygen into their businesses.

From a land surveyor in New England who is employing three times more workers than he did two years ago to a pet food manufacturer in Alaska who was finally able to buy an expensive new piece of equipment to increase his company's productivity the news is good among this critical segment of our economy.

And since small business creates two out of every three net new jobs, good news for small business is good news for Americans who are seeking work.

An interesting small-business story I heard recently that I think shows the underlying health of our economy – and the direct impact of the tax cuts – was from the owners of Mug-a-Bug Pest Control Inc. in Lawrenceville, Georgia. They report

that homeowners who had previously canceled their quarterly pest-control service during the slow days of the economy re-instated the service after tax cuts went into effect. As a result of the increase in business, Mug-a-Bug purchased five new route vehicles and hired three new employees.

Another great story came from Bob Ford, President Abrasive Blast Systems in Abilene, Kansas.

Bob has seen a big increase in orders at his small manufacturing firm from client businesses over the past two years due to the strengthening economy, enabling him to hire four additional workers in the past year, bringing his total number of employees to 20.

He said that in 2001 and early 2002, companies were very reluctant to spend money on the new equipment that he makes. But from mid-2002 through 2003 and 2004, he has seen a big increase (by at least 50%) in small companies placing orders for new equipment.

You'll often hear the President say that what's good for small business is good for America, and that's why his tax cuts were designed to help businesses like the ones represented in this room today.

When you are growing, the American economy is growing.

And it is important to remember that the benefit, the stimulating effect, of those tax cuts is ongoing.

Nearly 1.4 million business taxpayers like you in Florida will be able to use your tax savings this year to invest in new equipment, hire additional workers or increase employee compensation.

And more than 6.1 million individual taxpayers in Florida will have lower income tax bills for 2004 thanks to the President's tax relief.

When individuals and small-business owners are able to keep more of their own money to spend or invest they way they see fit, good economic news follows.

We still have challenges, to be sure. The price of oil is causing an economic headwind, and it's critical that the Congress act to pass the President's energy plan which has been stalled in the Senate. The Senate needs to act, and act now.

We need to enact his energy policy because it will make us less dependent on foreign sources of energy and help to keep and create energy industry jobs here in America. We've also got to conserve better, we've got to work on renewable energy sources, and we've got to explore in environmentally friendly ways in places like ANWR in Alaska. The President's plan will lead to lower costs, and that's very important for our economy.

High health care costs are another challenge for individuals, families and employers. The recently enacted Medicare prescription drug bill contains an innovative new program to empower consumers to make better health care choices. HSAs, Health Savings Accounts, are really super-charged IRAs that put patients back in charge of their health care. You own it, you control it, you can leave it to your heirs.

I believe we made real progress this year helping seniors to afford their prescriptions with the President's Medicare Drug Discount Cards. More than 4.1 million seniors are already using their cards, and I encourage others to take advantage of the new program by calling 1-800-MEDICARE, visiting www.medicare.gov or calling their state's Health Insurance Assistance Program (SHIP).

Seniors can use the card to save 15 to 30 percent off the usual retail price of most brand name drugs and more on generics at neighborhood pharmacies, and potential savings from the cards are even greater when seniors choose generics. Low-income seniors can get these savings and an additional $600 a year – $1,200

through the end of next year. This subsidy, combined with discounts available through the card, can save eligible seniors 32 to 86 percent off what they are now paying for their medicines.

These are reforms that impact people's day-to-day lives. Tax cuts have put more money back into the family budget. The Medicare drug benefit eases the budgets of seniors.

We are also impacted on a daily basis by our relationships with other countries, and the President is working tirelessly on those issues as well.

Our policy towards Cuba is, of course, of great interest to folks here in Florida. The objectives of United States policy towards Cuba are clear: bring an end to the ruthless and brutal dictatorship; assist the Cuban people in a transition to representative democracy; and assist the Cuban people in establishing a free market economy.

Both in October 2003 and May 2004, President Bush announced stepped-up initiatives intended to hasten the arrival of a new, free and democratic Cuba by strengthening enforcement of U.S. laws prohibiting travel-related transactions with the island.

The Treasury Department is implementing President Bush's strengthened regulations to help keep hard currency and travel-related dollars out of Castro's coffers.

These strengthened measures, which took affect June 30 th, include: issuing specific licenses for family travel; restricting family travel to once every three years; limiting family travel to two weeks in Cuba; extending family travel solely to immediate family; limiting the scope of remittances to immediate family; restricting the remittances U.S. visitors are allowed to carry to Cuba to $300; and requiring educational programs in Cuba have a 10-week minimum stay.

Estimates show between $700 million and $1.2 billion flows from the U.S. to Cuba each year. It is estimated that this amount will be cut by one-third under the strengthened measures, which would reduce flows from between $470 million and $804 million per year.

The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) is responsible for administering and enforcing the 29 sanction programs imposed by the United States against rogue nations. Cuba , because of its proximity and distinctive relationship with the United States , has a unique and critical sanction program which receives strict attention.

Our relationship with Haiti is unique as well, and I'd like to give you an update on that relationship.

The United States is continuing its role as a strong supporter of Haiti. At the July 20th donors conference, the United States pledged $230 million in additional grant assistance to Haiti as a part of the over $1 billion in new assistance the international community has mobilized for that country. Our aid will help to create jobs, provide clean water, build infrastructure, improve access to educational and health services, develop social safety nets, and strengthen institutional capacity. The Treasury Department has also played a special role in promoting rapid engagement by the IMF, World Bank, and Inter-American Development Bank with the interim Haitian government.

Treasury Under Secretary John Taylor traveled to Haiti in early July for discussions with government officials as well as private sector representatives on the policies needed to restore economic stability and lay the basis for sustained growth. Treasury technical assistance advisors have initiated work with the Haitian government to identify measures to strengthen tax administration, budget management, and financial crimes law enforcement.

From tax cuts to international relationships, your government is working hard, every day, to ensure your freedom and encourage your prosperity. Because we understand that government can't make your business grow... but we can create an

environment in which you have the room you need to flourish.

It's good to be here with you... I look forward to hearing your ideas and concerns, and thank you again for all you do for this great American economy.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 13, 2004
JS-1857

Australia-United States Financial Services Discussions

U.S. Treasury Secretary John W. Snow and Treasurer of Australia, the Honorable Peter Costello M.P., are pleased to note the enhanced economic relationship between the United States and Australia, including in the financial services sector. Direct and portfolio equity investment by the United States in Australia was US$105 billion as at the end of 2003, with equity investment in banks and other financial sector institutions of US$17 billion as at 30 June 2003. Direct and portfolio equity investment by Australian companies in the United States was estimated at US$118 billion as at the end of 2003. All of Australia's major banks have a presence in the United States, and there is increasing investment by Australia's mutual funds in the U.S. economy.

To further promote this relationship, Australia and the United States have agreed to consider issues regarding financial services, including ways to further integrate the financial services sectors between the two economies. The substantial levels of financial sector investment between the United States and Australia provide a sound basis for building on these economic ties through future discussions.

Both countries recognize the benefits of facilitating cross-border flows of business and high regulatory standards for investor protection. To this end, Australia and the United States will discuss certain issues relating to securities, including cross-border access by foreign collective investment schemes and foreign markets, other such prudential issues, and related matters. These discussions will take place as appropriate in light of related domestic regulatory developments.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 16, 2004
js-1858

Treasury International Capital (TIC) Data For June

Treasury International Capital (TIC) data for June are 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 July, is scheduled for September 16, 2004.

Long-Term Domestic Securities
Gross purchases of domestic securities by foreigners were $1,338.8 billion in June, exceeding gross sales of domestic securities by foreigners of $1,253.3 billion during the same month.

Foreign purchases of domestic securities reached $85.5 billion on a net basis in June, relative to $62.4 billion during the previous month. Private net flows reached $67.2 billion in June. Net private purchases of Treasury Bonds and Notes rose to $23.0 billion from $14.7 billion the preceding month. Net private purchases of Government Agency Bonds were $15.3 billion, down from $21.3 billion the previous month. Net private purchases of Corporate Bonds rose to $26.5 billion from $19.8 billion the previous month. Net private purchases of Equities increased to $2.4 billion from minus $7.8 billion.

Official net purchases of U.S. securities were $18.3 billion in June, relative to $14.5 billion in May. Official net purchases of Treasury Bonds and Notes of $17.5 billion accounted for the bulk of official inflows in June, up from $14.6 billion the previous month.

Long-Term Foreign Securities
Gross purchases of foreign securities owned by U.S. residents were $291.4 billion in June, relative to gross sales of foreign securities to U.S. residents of $305.1 billion during the same month.

Gross sales of foreign securities to U.S. residents exceeded purchases by $13.7 billion, highlighting a net U.S. acquisition of $7.5 billion in Foreign Equities and $6.2 billion in Foreign Bonds.

Net Long-Term Securities Flows
Net foreign purchases of both domestic and foreign long-term securities from U.S. residents were $71.8 billion in June compared with $65.2 billion in May. Net foreign purchases of long-term securities were $788.2 billion in the 12-months through June 2004 as compared to $694.7 billion during the twelve months through June 2003.

The full June data set, including adjustments for repayments of principal on asset-backed securities, as well as historical series, can be found on the TIC web site, www.treas.gov/tic/.

Revised data for the January 2003 through May 2004 period are being published this month for a number of series.

REPORTS

- Foreigners' Transactions in Long-Term Securities with U.S. Residents (PDF)
- Foreigners' Transactions in Long-Term Securities with U.S. Residents (Excel)

Foreigners' Transactions in Long-Term Securities with U.S. Residents

(Billions of dollars, not seasonally adjusted)

		2002	2003	12 Months Through June-03	12 Months Through June-04	Mar-04	Apr-04	May-04	Jun-04
1	Gross Purchases of Domestic Securities	13,022.9	14,922.1	13,932.3	16,509.3	1,645.1	1,596.9	1,522.6	1,338.8
2	Gross Sales of Domestic Securities	12,475.4	14,175.0	13,259.6	15,650.4	1,563.2	1,514.9	1,460.1	1,253.3
3	**Domestic Securities Purchased, net** (line 1 less line 2) /1	**547.6**	**747.1**	**672.8**	**858.9**	**81.9**	**82.1**	**62.4**	**85.5**
4	**Private, net /2**	**508.3**	**607.7**	589.3	624.3	**43.8**	**55.9**	**47.9**	**67.2**
5	Treasury Bonds & Notes, net	112.8	168.8	164.3	206.1	26.9	13.5	14.7	23.0
6	Gov't Agency Bonds, net	166.6	136.1	184.7	150.2	1.1	28.9	21.3	15.3
7	Corporate Bonds, net	176.7	264.7	199.7	254.8	29.3	15.9	19.8	26.5
8	Equities, net	52.2	38.1	40.6	13.2	-13.5	-2.4	-7.8	2.4
9	**Official, net**	**39.3**	**139.4**	**83.4**	**234.6**	**38.1**	**26.2**	**14.5**	**18.3**
10	Treasury Bonds & Notes, net	7.1	109.3	50.5	200.2	33.9	22.1	14.6	17.5
11	Gov't Agency Bonds, net	28.6	24.9	28.9	27.8	2.9	2.9	-0.7	0.6
12	Corporate Bonds, net	5.6	5.5	4.1	7.3	1.2	0.6	0.5	0.7
13	Equities, net	-2.0	-0.4	-0.2	-0.7	0.0	0.5	0.2	-0.5
14	Gross Purchases of Foreign Securities	2,640.0	3,060.1	2,747.5	3,563.5	382.4	303.3	293.3	291.4
15	Gross Sales of Foreign Securities	2,613.0	3,096.5	2,725.6	3,634.2	386.3	310.0	290.5	305.1
16	**Foreign Securities Purchased, net** (line 14 less line 15) /3	**27.0**	**-36.4**	**21.9**	**-70.7**	**-3.9**	**-6.7**	**2.8**	**-13.7**
17	Foreign Bonds Purchased, net	28.5	34.7	44.6	13.4	-1.0	4.7	8.6	-6.2
18	Foreign Equities Purchased, net	-1.5	-71.1	-22.7	-84.1	-2.9	-11.3	-5.8	-7.5
19	**Net Long-Term Flows** (linc 3 plus line 16)	**574.6**	**710.7**	**694.7**	**788.2**	**78.0**	**75.4**	**65.2**	**71.8**

/1 Net foreign purchases of U.S. securities (+)
/2 Includes International and Regional Organizations
/3 Net U.S. acquisitions of foreign securities (-)

Source: U.S. Department of the Treasury

FROM THE OFFICE OF PUBLIC AFFAIRS

August 17, 2004
2004-8-17-14-4-36-16105

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 $82,339 million as of the end of that week, compared to $82,145 million as of the end of the prior week.

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

	August 6, 2004			August 13, 2004		
TOTAL		82,145			82,339	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	11,044	14,293	25,337	11,127	14,213	25,340
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	10,913	2,872	13,785	10,990	2,856	13,846
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]			19,393			19,472
3. Special Drawing Rights (SDRs) [2]			12,586			12,638
4. Gold Stock [3]			11,044			11,044
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	August 6, 2004			August 13, 2004		
	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

	August 6, 2004			August 13, 2004		
	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 IMF data for the prior month end.

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

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 18, 2004
js-1859

UPDATED: Secretary Snow Visits Springfield, Missouri on Thursday

U.S. Treasury Secretary John W. Snow will visit Springfield, Missouri on Thursday, August 19 to meet with local business leaders and discuss the President's efforts to strengthen the economy and create jobs.

"As a result of the President's economic leadership, we have overcome a recession and seen 11 straight months of job creation, totaling nearly 1.5 million new U.S. jobs since August 2003," said Secretary Snow. "So far this year, Missouri has gained nearly 61,000 new jobs and the President's tax reform policies have ensured that more than 2 million Missouri taxpayers will have lower income tax bills in 2004."

During this trip to Missouri, Secretary Snow also will discuss the Administration's efforts to control health care costs, reduce frivolous lawsuits and ensure that America has reliable and affordable sources of energy.

Recent indicators show that President Bush's economic policies continue to move the economy forward. According to the Labor Department, the national unemployment rate declined to 5.5% in July – down 0.8 percentage point from a peak of 6.3% in June 2003 and the lowest rate since October 2001. At 5.5%, the unemployment rate is below the average of the 1970s, 1980s, and 1990s. Employment over the last year was up in 46 of the 50 states and the unemployment rate was down in all regions and in 47 of the 50 states.

The following events are open to the media, which must present media credentials or photo ID:

Thursday, August 19

Tour of Loren Cook Company
10:00 am CDT
2707 North Barnes, Building 5 (updated location)
Springfield, MO
** Media should arrive by 9:15 am

Remarks to Loren Cook Company officials and employees
10:45 am CDT
Loren Cook Company
2015 East Dale Street
Springfield, MO
** A brief press availability will occur immediately following the event

Remarks to Springfield Southeast Rotary
12:00 pm CDT
Mid-America Cancer Center
2055 South Fremont
Springfield, MO

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 18, 2004
js-1860

UPDATED: Secretary Snow Visits Des Moines, Iowa on Friday
Trip Will Include Launch of "Keelboat Nickel"

U.S. Treasury Secretary John W. Snow will visit Des Moines, Iowa on Friday, August 20 to meet with local business leaders and discuss the President's efforts to strengthen the economy and create jobs. He also will join U.S. Senator Charles Grassley to present the new "Keelboat Nickel" at the Iowa State Fair.

"As a result of the President's economic leadership, we have overcome a recession and seen 11 straight months of job creation, totaling nearly 1.5 million new U.S. jobs since August 2003," said Secretary Snow. "The President's tax reform policies have ensured that more than 1 million Iowa taxpayers will have lower income tax bills in 2004."

During this trip to Iowa, Secretary Snow also will discuss the Administration's efforts to control health care costs, reduce frivolous lawsuits and ensure that America has reliable and affordable sources of energy.

Recent indicators show that President Bush's economic policies continue to move the economy forward. According to the Labor Department, the national unemployment rate declined to 5.5% in July – down 0.8 percentage point from a peak of 6.3% in June 2003 and the lowest rate since October 2001. At 5.5%, the unemployment rate is below the average of the 1970s, 1980s, and 1990s. Employment over the last year was up in 46 of the 50 states and the unemployment rate was down in all regions and in 47 of the 50 states.

The following events are open to the media, which must present media credentials or photo ID:

Friday, August 20

Tour of the Iowa Clinic , P.C.
8:00 am CDT (updated time)
5950 University Avenue
West Des Moines, IA
** Media should arrive by 8:00 am

Presentation of the new "Keelboat Nickel", with Senator Charles Grassley
10:00 am CDT
Iowa State Fair
Riley Stage
East 30th Street and University Ave.
Des Moines, IA
** There will be an opportunity for media interviews following the event.
** Children who attend will receive a new nickel following the event, and adults may exchange their bills and coins for rolls of nickels.
** More information on the Keelboat Nickel:

The "Keelboat Nickel" is the second new design in the U.S. Mint's Westward Journey Nickel series, which commemorates Lewis and Clark's expedition and the Louisiana Purchase. The "Keelboat Nickel," which depicts the boat Lewis and Clark used in their expedition as they traveled the Missouri River in search of a northwest passage to the Pacific Ocean, is the second of two designs released in 2004. The first, released in March, features symbols of peace and friendship from the original Peace Medal commissioned for Lewis and Clark's expedition. The medals were

presented to Native American chiefs and other leaders as tokens of goodwill. Two additional designs will be released in 2005. A depiction of Monticello will return to the nickel in 2006.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 18, 2004
js-1861

Air Transportation Stabilization Board Names Mark Dayton Executive Director

The Air Transportation Stabilization Board (ATSB) announced today that it has named Mark Dayton as its new Executive Director. He is replacing Michael Kestenbaum, who has served as Executive Director since January of 2004. Mr. Kestenbaum is leaving the Board's staff to pursue an MBA at the Wharton School of the University of Pennsylvania.

Mr. Dayton is the Assistant Inspector General for Competition and Economic Analysis at the Department of the Transportation and will serve concurrently as the ATSB's Executive Director. He has been with the Department of Transportation since 1997 and has substantial experience in aviation matters. Previously, he held positions at the Congressional Budget Office, the Transportation Research Board of the National Academy of Sciences, and the School of Business at the University of Maryland.

The Chairman of the ATSB, Federal Reserve Board Governor Edward M. Gramlich, said "We are very pleased that Mark Dayton has agreed to take over as Executive Director. His background ideally positions him to play a vital role in the on-going work of the ATSB." Governor Gramlich also said "Michael Kestenbaum has made tremendous contributions to the ATSB over the past two and a half years. His analytical ability and leadership have been invaluable, and the ATSB wishes him well in his future endeavors."

Additional information on the ATSB is available on its Web site, www.treas.gov/atsb.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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

August 19, 2004
JS-1862

Treasury Issues Guidance On Funding Requirements For Employers Who Elected Funding Relief

The Treasury Department and IRS issued Notice 2004-59 providing guidance on the special funding rules that apply to pension plans sponsored by airlines, steel companies and others that are making the alternative deficit reduction contribution election provided for under the Pension Funding Equity Act of 2004. This Notice is in addition to the previously issued Announcements 2004-38, 2004-43 and 2004-51 that set forth the procedures and timing with respect to this election.

The Pension Funding Equity Act generally prohibits benefit improvements under a plan that makes the alternative deficit reduction contribution election, but provides for certain exceptions. One exception is where the plan's enrolled actuary certifies that the amendment provides for an increase in annual contributions that will exceed the increase in annual minimum funding requirements for the plan attributable to the plan amendment. Notice 2004-59 provides rules for the application of this exception.

A copy of Notice 2004-59 is attached

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REPORTS

- Notice 2004-59

Part III – Administrative, Procedural and Miscellaneous

Plan Amendments Following Election of Alternative Deficit Reduction Contribution

Notice 2004-59

This notice provides guidance on the restrictions that are placed on plan amendments following an employer's election of the alternative deficit reduction contribution under § 412(l)(12) of the Internal Revenue Code (the "Code") and section 302(d)(12) of the Employee Retirement Income Security Act of 1974 ("ERISA"), as added by section 102 of the Pension Funding Equity Act of 2004, Pub. L. 108-218 ("PFEA '04").

I. Background

Section 102 of PFEA '04, which was enacted on April 10, 2004, added § 412(l)(12) to the Code and section 302(d)(12) to ERISA. Section 412(l)(12) of the Code permits certain employers who are required to make additional contributions under § 412(l) to elect a reduced amount of those contributions ("alternative deficit reduction contributions") for certain plan years. An employer is eligible to make such an election if it is (1) a commercial passenger airline, (2) primarily engaged in the production or manufacture of a steel mill product or the processing of iron ore pellets, or (3) an organization described in § 501(c)(5) that established a plan on June 30, 1955, to which § 412 now applies. On April 12, 2004, the Internal Revenue Service (the "Service") issued Announcement 2004-38, 2004-18 I.R.B. 878, which provides guidance for making the election for an alternative deficit reduction contribution. On May 6, 2004, the Service issued Announcement 2004-43, 2004-21 I.R.B. 955 (corrected by Announcement 2004-51, 2004-23 I.R.B. 1041), which provides further guidance for making the election for the alternative deficit reduction contribution and provides guidance regarding notices that must be provided to participants, beneficiaries, and the Pension Benefit Guaranty Corporation following the making of the election.

Section 412(l)(12)(B) provides that no amendment that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan shall be adopted during any applicable plan year, unless (1) the plan's enrolled actuary certifies (in such form and manner prescribed by the Secretary) that the amendment provides for an increase in annual contributions that will exceed the increase in annual charges to the funding standard account attributable to such amendment, or (2) the amendment is required by a collective bargaining agreement that is in effect on April 10, 2004. Section 412(l)(12)(B) further provides that, if a plan is amended during any applicable plan year (i.e., a plan year for which the § 412(l)(12) election is

made) in violation of the preceding sentence, any election under § 412(l)(12) shall not apply to any applicable plan year ending on or after the date on which the amendment is adopted.

Section 302 of ERISA contains minimum funding standard requirements that are parallel to those under § 412 of the Code, and section 302(d)(12) of ERISA provides an election that is identical to the election under § 412(l)(12) of the Code. Under section 101 of Reorganization Plan No. 4 of 1978, 1979-1 C.B. 480, the Secretary of the Treasury has sole interpretive authority over the interpretation of section 302(d)(12) of ERISA. Accordingly, the guidance set forth in this notice applies as well under section 302(d)(12) of ERISA.

Section 412(c)(12) of the Code provides that, in determining projected benefits, the funding method of a collectively bargained plan (other than a multiemployer plan) shall anticipate benefit increases scheduled to take effect during the term of the collective bargaining agreement applicable to the plan.

Section 1.412(c)(3)-1(d)(1)(i) of the Income Tax Regulations provides that, except as otherwise provided by the Commissioner, a reasonable funding method does not anticipate changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective after the first day of, but during, a current plan year.

Rev. Rul. 77-2, 1977-1 C.B. 120, provides guidance regarding the minimum funding requirements with respect to a change in the benefit structure of a qualified pension plan that becomes effective during a plan year. Section 2.02 of Rev. Rul. 77-2 provides that, in the case of a change in the benefit structure that becomes effective as of a date during a plan year (but subsequent to the first day in such plan year), the charges and credits to the funding standard account shall not reflect the change in such benefit structure for the portion of such plan year prior to the effective date of such change, and shall reflect the change in such benefit structure for the portion of the plan year subsequent to the effective date of the change. Section 3 of Rev. Rul. 77-2 provides that, in determining the charges and credits for the plan year, in lieu of using the rule of section 2.02, a plan is permitted to disregard a change in benefit structure that is adopted after the valuation date for the year.

Section 412(c)(8) provides that any amendment applying to a plan year that is adopted after the close of the plan year but no later than 2 ½ months after the close of the plan year and that does not reduce the accrued benefit of any participant determined as of the beginning of the first plan year to which the amendment relates shall, at the election of the plan administrator, be deemed to have been made on the first day of such plan year (subject to additional restrictions on plan amendments that reduce benefits). Pursuant to Rev. Proc. 94-42, 1994-1 C.B. 717 and Rev. Rul. 79-325, 1979-2 C.B. 190, § 412(c)(8) also applies to plan amendments adopted during the plan year to which the amendment relates.

adopted and in effect before the beginning of the plan year are not treated as restricted amendments.

Q-2. What plan terms must a restricted amendment include?

A-2. A restricted amendment must include terms that require that contributions to the plan for all plan years in which the alternative deficit reduction contribution election is in effect will exceed the § 412(l)(12)(B) amount described in Q&A-3 of this notice. A restricted amendment may satisfy this requirement by reflecting the formula for the § 412(l)(12)(B) amount set forth in Q&A-3 of this notice. Alternatively, a restricted amendment may satisfy this requirement by providing for a dollar amount of contributions or for some other method of determining contributions if the amount of contributions specified in the plan exceeds the § 412(l)(12)(B) amount. For this purpose, the terms of a collective bargaining agreement pursuant to which a plan is maintained are deemed included in plan terms.

If a restricted amendment is adopted prior to August 31, 2004, the plan complies with this Q&A-2 if, no later than October 31, 2004, the plan is amended to provide for contributions that exceed the § 412(l)(12)(B) amount.

Q-3. How is the § 412(l)(12)(B) amount determined?

A-3. The § 412(l)(12)(B) amount is equal to the sum of the minimum required contribution under § 412 determined as if the restricted amendment had not been made (taking into account the alternative deficit reduction contribution election) plus the incremental amendment amount. The incremental amendment amount is equal to the difference between the required minimum contribution under § 412 that would have been due taking into account the restricted amendment and the required minimum contribution under § 412 that would have been due disregarding the restricted amendment. These two calculations are made as if the alternative deficit reduction contribution had not been elected. The calculation of the required minimum contribution under § 412 that would have been due taking into account the restricted amendment generally is made as if the amendment had been adopted and made effective on the first day of the plan year (i.e., the amendment must be fully reflected in plan costs for this purpose). However, if the amendment does not provide for benefit increases attributable to service prior to the beginning of the plan year, and is not effective as of the first day of the plan year, the amendment may instead be treated in accordance with the rules of section 2.02 of Rev. Rul. 77-2. In addition, the rules of § 412(c)(12) apply to the determination of the § 412(l)(12)(B) amount. For rules regarding the treatment of a credit balance generated as a result of contributions made with respect to the § 412(l)(12)(B) amount for the prior plan year, see Q&A-5.

The § 412(l)(12)(B) amount is computed without regard to any funding waiver for the plan year. Accordingly, the terms of a restricted amendment do not comply with § 412(l)(12)(B) if, under the terms of the plan as amended by the restricted

amendment, any portion of the contribution in excess of the incremental amendment need not be made if a funding waiver is granted.

Q-4. How does the § 412(l)(12)(B) amount affect the application of the minimum funding requirements of § 412?

A-4. The § 412(l)(12)(B) amount does not affect the computation of minimum required contributions under § 412. Thus, for example, quarterly contributions under § 412(m) are not required to reflect the minimum contribution required to maintain the applicability of the alternative deficit reduction contribution election. If an amount in excess of minimum required contributions is contributed for a plan year on account of the § 412(l)(12)(B) amount, the plan's funding standard account will reflect a credit balance on account of the excess. In addition, even if an amendment is considered adopted in a later year or years for purposes of determining whether an amendment is a restricted amendment for a plan year for purposes of applying § 412(l)(12)(B), the rules of § 412(c)(12) (requiring the funding method of a collectively bargained plan to take into account certain anticipated benefit increases) may require the amendment to be taken into account at an earlier time for purposes of computing minimum required contributions under § 412.

Q-5: How does a credit balance generated as a result of contributions made with respect to the § 412(l)(12)(B) amount for the prior plan year affect the computation of the § 412(l)(12)(B) amount for the plan year?

A-5: If a restricted amendment was adopted in a prior plan year for which the alternative deficit reduction contribution election was made, the credit balance resulting from the excess of the § 412(l)(12)(B) amount for the prior plan year over the minimum required contribution for the prior plan year must be disregarded in computing the § 412(l)(12)(B) amount for the current plan year. Thus, for example, assume that an employer elects the alternative deficit reduction contribution for both the 2004 and 2005 calendar plan years, adopts a restricted amendment during the 2004 plan year, and contributes the § 412(l)(12)(B) amount for the 2004 plan year, creating a credit balance as of the end of the 2004 plan year. The determination of the § 412(l)(12)(B) amount for the 2005 plan year (which reflects the restricted amendment adopted in 2004 as well as any restricted amendments adopted in 2005) is made as if there were no credit balance resulting from the excess of the § 412(l)(12)(B) amount for the 2004 plan year over the minimum required contribution for the 2004 plan year. However, if the contributions made for the 2004 plan year exceed the § 412(l)(12)(B) amount for that plan year, the credit balance attributable to that excess can be taken into account in determining the § 412(l)(12)(B) amount for 2005.

Q-6. How does the plan's enrolled actuary certify that a restricted amendment provides for an increase in annual contributions that will exceed the increase in annual charges to the funding standard account attributable to such amendment?

A-6. The plan's enrolled actuary certifies that a restricted amendment provides for an increase in annual contributions that will exceed the increase in annual charges to the funding standard account attributable to such amendment by filing a certification with the Service that, following the adoption of the plan amendment, the plan includes terms to the effect that contributions to the plan while the alternative deficit reduction contribution election is in effect will exceed the § 412(l)(12)(B) amount described in Q&A-3 of this notice. The certification may be based either on plan terms incorporating the formula described in Q&A-3 or on plan terms providing for either an amount of contributions or an alternative formula for contributions under which contributions for the plan year will exceed the § 412(l)(12)(B) amount. The certification must also provide the derivation of the § 412(l)(12)(B) amount as well as the amount of contributions required under the terms of the plan (if determined under an alternative formula).

The certification with respect to a restricted amendment made during a plan year must be filed on or before the due date for the filing of Form 5500 for the plan year at the following address:

Internal Revenue Service
Commissioner, Tax Exempt and Government Entities Division
Attention: SE:T:EP:RA:T
Alternative DRC Election Amendment Certification
P.O. Box 27063
McPherson Station
Washington, D.C. 20038

Q-7. What are the consequences of failure to include the plan terms required under § 412(l)(12)(B) as part of a restricted amendment?

A-7. If a restricted amendment does not contain the plan terms required under § 412(l)(12)(B) in a plan year, then the alternative deficit reduction contribution election is no longer valid for the plan year and cannot be made in any succeeding plan year.

Q-8. What are the consequences of failure to contribute the amount required under a restricted amendment that includes plan terms that satisfies the plan language requirements of § 412(l)(12)(B)?

A-8. If the contribution required under the terms of a restricted amendment is not made on or before the due date for contributions for the plan year, then the alternative deficit reduction contribution election is no longer valid for the plan year and cannot be made in any succeeding plan year.

Paperwork Reduction Act

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1889.

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.

The collection of information in this notice is in Q&A-6. This information is required to meet the requirements of section 102 of the Pension Funding Equity Act of 2004 to monitor and make valid determinations with respect to employers that elect an alternative deficit reduction contribution for certain plans and make restricted amendments. As a result of such elections, an employer's deficit reduction contribution for certain plans will be based on amounts specified under § 412(l)(12) of the Code. The likely respondents are businesses or other for-profit institutions, and nonprofit institutions.

The estimated total annual reporting and/or recordkeeping burden is 400 hours.

The estimated annual burden per respondent/recordkeeper varies from 3 to 5 hours, depending on individual circumstances, with an estimated average of 4 hours. The estimated number of respondents and/or recordkeepers is 100.

The estimated frequency of responses is occasional.

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.

Drafting Information

The principal authors of this notice are James E. Holland of the Employee Plans, Tax Exempt and Government Entities Division and Linda S. F. Marshall of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). Mr. Holland may be reached at 202-283-9699. (not a toll-free number).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 19, 2004
JS-1863

The Honorable John W. Snow Prepared Remarks: Loren Cook Company Springfield, MO

Thanks so much for having me here today. It's terrific to be in Springfield, and I'm delighted to have the opportunity to visit Loren Cook Company.

This is a thriving, growing business and I appreciate all you do to create good jobs for hundreds of Springfield's citizens.

Your company has a great philosophy about growth and what it means to be an industry leader. You say that leading the industry doesn't necessarily mean you're the biggest... it means that everyone else is following you. You are dedicated to product quality and customer service, and it's paying off. It looks like you're about to have the best month in your company's history; congratulations!

Companies like yours are a powerful reminder of what the American economy is made of: families, businesses more committed to innovation and quality than size, and workers that are dedicated to excellence.

As Loren Cook has risen to a leadership position in the ventilation industry, so many have benefited: your customers, your employees, and the Springfield community. Because your success has meant **jobs** for Missourians, quality products for your customers and opportunities for your many suppliers.

When you look at the American economy, it is really a collection of businesses that have much in common with Loren Cook. Some are larger, many are smaller... but those that do well are generally leading their communities by developing innovative methods or technology, or beating the competition when it comes to customer service.

This country has always encouraged entrepreneurship... and it became an early and lasting building block of this economy which is the strongest and most dynamic in the world.

Individually, each company – large or small – benefits its community by providing jobs. And in times like these, when we're recovering from a recession, every new job has the potential to change a family's life.

Nothing is more important here in Missouri than having enough jobs for all those who seek work. Really, nothing is more important to families all over the country.

We've come through hard times – here in Missouri and all over America . Our economy was in steep decline when the President took office, and September 11 th and the corporate scandals literally kicked us when we were down.

But the President's tax cuts served America with a helping of economic relief. Everyone who paid taxes got a tax cut; they got to keep more of their hard-earned money, and spend it how they saw fit. The President favored a tax cut because he wants people to have more of their money in their pockets. After all, it is your money – not the government's. Because of the President's tax legislation, owners of small businesses invested in equipment or increased pay for employees, or even hired new ones. Because of that legislation, workers had more money in their pockets so they could afford a payment on a new car or replace old household appliances with new ones. And the legislation reflected important American family

values – the value of marriage, children and families. All benefited from the legislation.

The tax cuts made a difference – individually and collectively. They are a critical part of the reason why I am able to report that our national economy has found its footing. It is expanding and creating jobs.

Growth among companies like yours is strengthening our economy on both the local and national levels. Although the President wants even stronger job growth, the good news is that jobs have been added to the national payrolls for 11 months in a row.

Here in Missouri, job growth has seen a recent upswing, with nearly 28,000 jobs created in June. That was the best news possible for Missouri families.

The President and I want all job-seekers to be rewarded with paychecks, and we know that the reward cannot come soon enough for workers and their families. Even though lots of new jobs have been created in the last year, we're not satisfied. More needs to be done.

The underlying fundamentals of our economy are very strong. We've seen that tax cuts work and that job creation does follow economic growth. I'm optimistic.

Small businesses are hiring, and they are optimistic. Consumer confidence is high, too... and these are both good indicators that we will see continued economic growth and job creation.

Yesterday's reports on the economy were encouraging. They show that we're going the right way with strong manufacturing output, home sales continuing at near-record levels and very low inflation. Overall homeownership is at the highest level in the history of the country, as is minority homeownership. More Americans are working than ever before, and keeping what they earn more than ever before... all because of the President's tax cuts.

Keeping your taxes low is critical at a time like this, when we need more growth and continued job creation.

Here in Missouri , more than 2 million taxpayers will have lower income tax bills in 2004 thanks to the President's tax cuts. About 440,000 Missouri business taxpayers will be able to use their tax savings to invest in their employees' pay or benefits, the purchase of new equipment, or hiring of new staff.

Raising your taxes right now would be terrible news for our economy, and for every Missourian who seeks work. It would take us in the wrong direction, imperil the recovery and put the American economy at risk.

We need to keep the burden of taxes as light as we can on small businesses and individuals if we want to encourage the creativity and innovation that leads to job creation.

Because when individuals and small-business owners are able to keep more of their own money to spend or invest the way they see fit, good economic news follows.

We still have challenges, to be sure. The price of oil is causing an economic headwind, and it's critical that the Congress act to pass the President's energy plan which has been stalled in the Senate. The Senate needs to act, and act now.

We need to enact his energy policy because it will make us less dependent on foreign sources of energy and help to keep and create energy industry jobs here in America. We've also got to conserve better, we've got to work on renewable energy sources, and we've got to explore in environmentally friendly ways in places like ANWR in Alaska. The President's plan will lead to lower costs, and that's very important for our economy.

High health care costs are another challenge for individuals, families and employers. The recently enacted Medicare prescription drug bill contains an innovative new program to empower consumers to make better health care choices. HSAs, Health Savings Accounts, are really super-charged IRAs that put patients back in charge of their health care. You own it, you control it, you can leave it to your heirs.

The President also needs Congress to act and pass Association Health Plans, so small businesses and their employees can band together, across state lines, to purchase health insurance at a much more affordable rate.

More affordable health insurance would be a big help to America 's smallest companies... and they are the ones creating most of the new jobs, so their needs are a priority for the President.

I am concerned with the economic impact that baseless, abusive lawsuits have... again, especially on smaller businesses. The threat of these frivolous lawsuits is a disincentive for expansion and hiring. And while justice for victims must always remain as the ultimate goal of the system, we can and must make changes that make it harder for wealthy lawyers to make their own financial gain the primary outcome of personal injury suits.

There is work to be done in many areas to shore up our economy, and to spur increased job creation. But we are fortunate that our economy is the most open, flexible, adaptive and resilient in the world. As long as we continue on the path of freedom, making sure that individuals and entrepreneurs have an environment in which they can work and grow, our best days will remain ahead of us, all across this great country.

Thank you again for the work you do to keep our economy strong, and thank you for having me here today.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 19, 2004
js-1864

MEDIA ADVISORY: Under Secretary Taylor Visits Tampa, Florida on Friday

U.S. Treasury Under Secretary International Affairs John Taylor will visit Tampa, Florida on Friday, August 20 to meet with local business leaders and discuss the President's efforts to strengthen the economy and create jobs.

Recent indicators show that President Bush's economic policies continue to move the economy forward. According to the Labor Department, Florida has created nearly 82,000 jobs since the beginning of this year, including nearly 12,000 in June. Florida's unemployment rate, at 4.7 percent, is lower than the national unemployment rate.

The national unemployment rate declined to 5.5 percent in July – down 0.8 percentage points from a peak of 6.3 percent in June 2003 and the lowest rate since October 2001. At 5.5 percent, the unemployment rate is below the average of the 1970s, 1980s and 1990s. Employment over the last year was up in 46 of the 50 states and the unemployment rate was down in all regions and in 47 of the 50 states.

The following events are open to the media, which must present media credentials or photo ID:

Friday, August 20

Roundtable Discussion with Representatives from the Greater Tampa Chamber of Commerce and The Beck Group
1:00 pm EST
615 Channelside Drive, Suite 108
Tampa, FL 33602
***Media should arrive by 12:45 pm*

Tour of Victory Loft Construction Site
1:30 pm EST
101 South 12th Street
Tampa, FL 33602
*** A brief press availability will occur immediately following the event*

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 19, 2004
js-1865

Debt For Nature Agreement To Conserve Panama's Forests

On August 19, 2004, the Governments of the United States of America and the Republic of Panama, together with The Nature Conservancy, signed a second round of agreements reducing Panamá's debt to the United States and generating nearly $11 million for tropical forest conservation over the next 12 years. These funds will be used to conserve the biologically rich forest resources of the Darien National Park, bringing to $21 million the total funds made available to Panama for conservation purposes under the Tropical Forest Conservation Act.

Today's agreements were signed by United States Ambassador to Panamá Linda Watt, Panamanian Finance and Economy Minister Norberto Delgado, and The Nature Conservancy Panama Program Director George Hanily. The agreements were made possible through a grant of $6.5 million from the United States government and a contribution of $1.3 million from The Nature Conservancy. The first debt-for-nature swap with Panama, signed in 2003, will generate $10 million over 14 years to conserve Chagres National Park in the Panama Canal watershed.

The forests of Darien National Park contain a unique biological land bridge where North and South America meet. Covering nearly 1.4 million acres (579,000 hectares), the park is an exceptionally rich area of the American tropics, sheltering a diverse range of flora and fauna and forming an essential part of bird migration routes. The park contains such rare species as the jaguar, harpy eagle, wild dog and tapir. High annual rainfall provides a flow of sediments to the Gulf of San Miguel, which nourishes the productive mangrove coastal forests of Punta Patino.

The agreements signed today will help protect these valuable resources by funding grants to primarily nongovernmental organizations and creating a permanent endowment to provide sustainable funding for park management.

The Tropical Forest Conservation Act of 1998 was first funded in 2000 to provide eligible developing countries opportunities to reduce concessional debts owed the United States while generating funds to conserve their forests. Panama is one of seven countries to benefit from the Act so far and the first country to benefit a second time. Others countries are Bangladesh, Belize, Colombia, El Salvador, the Philippines and Peru.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 20, 2004
js-1866

The Honorable John W. Snow
Prepared Remarks: Iowa State Fair
Presentation of the new "Keelboat Nickel"

Thank you so much for having me here today – I'm delighted to be able to visit the famous Iowa State Fair!

And it's terrific to be with my friend Senator Grassley; I can't think of a better person to tour these fairgrounds with. We're both excited to be here to talk about the new series of nickels from the U.S. Mint.

The release of new coinage and currency is a great part of my job. I'm humbled to have my signature on our paper currency and impressed to see our technological advances against counterfeiting. I'm also very interested in the rich history of our coins. As Treasury Secretary, I get a lot of interesting questions about money – like, why is it green or why is the nickel bigger than the dime?

Since we're here to talk about the nickel, I'll answer that one for you.

Back in 1793, when the first U.S. coins were produced, the U.S. Mint linked the sizes of coins to a particular metal standard--the silver dollar.

Except for the copper penny, all coins were produced in proportionate metallic content to the dollar, and their sizes were regulated accordingly. The fifty-cent coin contained one-half as much silver as the dollar, the quarter had one-fourth as much, and the dime or ten-cent coin had one-tenth as much.

The five-cent coin, or half-dime as it was called then, had only one-twentieth the silver. But it was so small that it was difficult for people to handle. So in 1866, Mint officials decided to make it larger by changing its content from silver and copper to a combination of copper and **nickel**--and the modern nickel was born.

President Thomas Jefferson's profile has graced the nickel since 1938. It is therefore appropriate that we should use this coin to commemorate an historic journey of discovery and exploration that began at his behest: the Lewis and Clark expedition.

As Senator Grassley mentioned, the hope at the time was to find a waterway that could serve as a passage to the west coast, which would have been an incredible boon for international trade and commerce.

The Keelboat shown on this new nickel was the incredibly versatile vehicle used by the expedition to carry them and their supplies through the rivers of the Louisiana Territory in search of that passage.

Although no great northwest passage was to be found, the expedition of Lewis and Clark was of immeasurable value to our growing country.

Thomas Jefferson, a man who personified the phrase "ahead of his time," knew that a waterway would be an unprecedented advance for U.S. and global commerce. But he also understood that exploring the west, and mapping it, would be of great value for a multitude of reasons. He instructed Lewis to collect information that would add to the nation's strategic and military knowledge and that would help assess the economic value of the new territory.

Jefferson anticipated the need for the country to expand; he saw the need for more land... especially for agriculture.

How right he was... and so I think it is appropriate that we are unveiling this new coin in Iowa on the same weekend that we celebrate Iowa's agricultural economy at the State Fair.

There's a lot of pride in being a farmer, and plenty of hardship as well. Agriculture is a critical part of our economic fabric. It remains a great source of strength for our country. And American farmers literally feed the world.

Agricultural feels the pain when our country takes a blow, like it did after September 11th, the bursting of the stock market bubble and the corporate scandals. And you also have a business partner that many don't have to worry about as much: Mother Nature. And she can be the best business partner in Iowa, or she can be your worst nightmare.

My top priority as Treasury Secretary, and George W. Bush's top domestic priority as your President, is to keep the tax burden as low on individuals, farmers and business owners as we can. Because you are the folks who make this great American economy run, and you don't need Uncle Sam slowing you down.

Thanks in large part to the President's leadership on tax cuts, our economy is doing much better. GDP growth has been strong and good jobs are being created all over America. Although the President would like to see even stronger job growth, the good news is that jobs have been added to the national payrolls for 11 months in a row.

The President and I want all job-seekers to be rewarded with paychecks, and we know that the reward cannot come soon enough for workers and their families looking for work. While lots of new jobs have been created in the last year, we're not satisfied. More needs to be done.

The underlying fundamentals of our economy are very strong. We've seen that tax cuts work and that job creation does follow economic growth. I'm optimistic. I'm confident we are on the right course.

One of the reasons for my optimism comes from the people I meet on the road, all over this great country. Everywhere I travel, I meet with small-business owners, the people who drive our economy. And everywhere I go, they tell me that they are using their tax savings to grow their business and hire new employees; they know that the president's tax cuts have made all the difference in the world to them, putting oxygen into their businesses.

I recently visited a chocolate factory in New Hampshire where, because of the President's tax policy, they've been hiring *and* have opened a new facility. I also spent time with a small manufacturer in Alaska who, thanks to the President's tax cuts for small business, was finally able to buy an expensive new piece of equipment to increase his company's productivity.

Wherever I go, I find that the news is good among this critical segment of our economy – and what's good for small business is good for growth, jobs and greater prosperity for all Americans.

Small business creates two-thirds of new private sector jobs in America. It employs more than half of all workers, and accounts for more than half of the output of our economy. Good news for small business is good news for Americans who are seeking work.

You'll often hear the President say that: what's good for small business is good for America. That's why his tax cuts were designed to help small businesses – a lot of whom are farmers.

Because when small business is growing, the American economy is growing.

And it is important to remember that the benefit, the stimulating effect, of those tax

cuts is ongoing.

More than 280,000 million business taxpayers in Iowa will be able to use tax savings this year to invest in new equipment, hire additional workers or increase employee compensation.

And more than 1 million individual taxpayers in Iowa will have lower income tax bills for 2004 thanks to the President's tax relief.

When individuals and small-business owners are able to keep more of their own money to spend or invest they way they see fit, good economic news follows.

We still have challenges, to be sure. The price of oil is causing an economic headwind, and it's critical that the Congress act to pass the President's energy plan which has been stalled in the Senate. The Senate needs to act, and act now.

We need to enact his energy policy because it will make us less dependent on foreign sources of energy and help to keep and create energy industry jobs here in America. We've also got to conserve better, we've got to work on renewable energy sources like ethanol, and we've got to explore in environmentally friendly ways to increase U.S. energy output in places like ANWR in Alaska. The President's plan will lead to lower energy costs, and that's very important for our economy.

High health care costs are another challenge for individuals, families and employers. The recently enacted Medicare prescription drug bill contains an innovative new program to empower consumers to make better health care choices. HSAs, Health Savings Accounts, are really super-charged IRAs that put patients back in charge of their health care. You own it, you control it, you can leave it to your heirs.

The President also needs Congress to act and pass Association Health Plans, so small businesses and their employees can band together, across state lines, to purchase health insurance at a much more affordable rate.

More affordable health insurance would be a big help to America's smallest companies... and they are the ones creating most of the new jobs, so their needs are a priority for the President.

I am concerned with the economic impact that baseless, abusive lawsuits have – again, especially on smaller businesses. The threat of lawsuits can be a disincentive for expansion and hiring. And while justice for victims must always remain as the ultimate goal of the system, we can and must make changes that make it harder for wealthy lawyers to make their own financial gain the primary outcome of personal injury suits.

And although we've done great things for our economy with tax cuts, we've still got to convince Congress to make those tax cuts permanent. The President even got them to take the death tax out of the tax code, but a legislative detail is allowing that punishing tax to come back in a few years.

We can't stand for that. The death tax has got to be buried forever. The farmers of Iowa should never have to wonder whether they can pass their land on to their children. Your family business has been taxed enough; you don't need to be taxed again when you die!

Indeed, there is work to be done in many areas to shore up our economy, and to spur increased job creation. But we are already fortunate that our economy is more open, flexible, adaptive and resilient than any other in the world. As long as we continue on the path of freedom, making sure that individuals and entrepreneurs like all of you have an environment in which they can work and grow, our best days will remain ahead of us, all across this great country.

Thank you again for the work you do to keep our economy strong, and thank you for having me here today.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 23, 2004
js-1867

Treasury Calls for Large Position Reports

The Treasury is calling for Large Position Reports from those entities whose reportable position in the 4% Treasury Notes of June 2009 equals or exceeds $2 billion as of close of business **Wednesday, August 18, 2004**. This call for Large Position Reports is a test. Entities with reportable positions in this note equal to or exceeding this $2 billion threshold must report these positions to the Federal Reserve Bank of New York. Entities with positions in this note below $2 billion are not required to file Large Position Reports. Reports must be received by the Government Securities Dealer Statistics Unit of the Federal Reserve Bank of New York before noon Eastern Time on **Friday, August 27, 2004,** and must include the required position and administrative information. Large Position Reports may be faxed to (212) 720-5030 or delivered to the Bank at 33 Liberty Street, 4th floor.

Details on Call for Large Position Reports

Security Description: 4% Treasury Notes of June 2009, Series J-2009

CUSIP Number: 912828 CL 2

CUSIP Number of STRIPS Principal Component: 912820 KH 9

Maturity Date: June 15, 2009

Date for Which Information Must Be Reported: August 18, 2004 as of COB

Large Position Reporting Threshold: $2 Billion (Par Value)

Date Report Is Due: August 27, 2004, before noon Eastern time

This call for large position information is made under Treasury's large position reporting rules (17 CFR Part 420). The notice calling for Large Position Reports is also being published in the *Federal Register*. This press release and a copy of a sample Large Position Report, which appears in Appendix B of the rules at 17 CFR Part 420, are available at the Bureau of the Public Debt's Internet site at www.publicdebt.treas.gov.

Questions about Treasury's large position reporting rules should be directed to Treasury's Government Securities Regulations Staff at Public Debt on (202) 504-3632. Questions regarding the method of submission of Large Position Reports should be directed to the Government Securities Dealer Statistics Unit of the Federal Reserve Bank of New York at (212) 720-7993.

BACKGROUND INFORMATION

Treasury's large position reporting rules (17 CFR Part 420), which were issued in final form on September 12, 1996 (61 FR 48338), established recordkeeping and reporting requirements for entities that control large positions in certain Treasury securities. An amendment to the rules was issued on December 18, 2002, and was effective January 17, 2003. The rules put in place an on-demand reporting system which, in response to a notice by Treasury requesting large position information,

requires large position reports to be filed by entities that control a position in a particular Treasury security or securities equaling or exceeding the specified large position threshold. Holders will have three and one-half days in which to respond to the request.

The rules were first effective March 31, 1997. When the rules were announced, Treasury said that it would issue a test call annually. Treasury has issued six test calls to date.

The purpose of the rules is to give Treasury the means to acquire information quickly on concentrations of a security's holdings in the event of a market dislocation affecting that security. The rules are intended to improve the information available to Treasury and other regulators regarding concentrations of control and to ensure that regulators have the tools necessary to monitor the Treasury securities market. Large positions, in and of themselves, are not inherently harmful, and there is no presumption of manipulative or illegal intent on the part of a controlling entity merely because it is required to submit a large position report in response to these rules. The Treasury does not expect to have to use such authority for such purposes frequently, but it wants holders' reporting systems to be fully functional in the event it needs to require large position information.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 23, 2004
JS-1868

The Undersecretary Taylor's remarks on Haiti Economic Reconstruction

John B. Taylor Under Secretary of Treasury for International Affairs Roundtable Meeting with Haitian Community Leadership Organized by the Florida Association for Volunteer Action in the Caribbean and the Americas Jean-Jacques Dessaline Community Center
Miami, Florida - August 23, 2004

I would like to begin by thanking Julieta Valls and Rebecca Reichert of the Florida Association for Volunteer Action in the Caribbean and the Americas (FAVACA) for coordinating this event, as well as Jorge Arrizurieta and Nicole de Lara of Florida FTAA, Inc., for their assistance in making today's meeting happen. I am pleased to be here today and see the continued strong interest and commitment to Haiti.

I would like to take this opportunity to discuss the Bush Administration's efforts to work with the international community to support economic reconstruction in Haiti. I will argue that there are two essential ingredients to this effort: measuring results and encouraging the private sector and the Haitian Diaspora to play a significant role.

The Role of the Bush Administration and International Community

When the new Haitian government took office earlier this year, it faced an enormous array of challenges. I am pleased to say that in the area I know best--the economic sphere--the new authorities have shown their commitment to address these challenges. Although they immediately confronted a severe fiscal crisis, with few government funds to meet increasing needs for government services, they refrained from the all too familiar route of printing money and sparking uncontrolled inflation. Instead, they moved swiftly to restore the government's revenue base, collect unpaid back taxes, and restrain spending to levels that could be covered by incoming revenues. At the same time, the new government took actions to restore basic services such as electrical power generation, supported by expeditious assistance from the United States.

The United States and its partners in the international community have responded quickly to assist the Haitian government in addressing Haiti's urgent needs and begin to lay the basis for economic growth. Experts from 26 governments and multilateral institutions traveled to Haiti this spring to work with the government in creating a plan to rebuild Haiti's infrastructure, strengthen institutions, and improve basic services. This international effort culminated in a two-year plan--known as the Interim Cooperation Framework (ICF)--which outlines the government's strategy to tackle the priority needs identified through this process. This plan also serves as a framework for donors to find a way a help.

On July 20, the international community came together to pledge over $1 billion in assistance to meet the needs identified in the ICF over the next two years. The United States committed to provide $230 million. This is on top of the more than $850 million in aid the U.S. has provided since 1995. The Inter-American Development Bank, World Bank, and International Monetary Fund--all institutions with which Treasury works closely--were also critical to making the donors conference a success.

This was a successful first step. Now the important work begins to build the roads, schools, health clinics, and other institutions this assistance is intended to produce. We cannot forget that in the mid-1990s, there was a similar donor effort with large pledges of international assistance. However, that assistance failed to improve the living standards of the Haitian people. We need to learn from the mistakes of the past and ensure that things are different this time around.

Part of that means applying a theme that President Bush has emphasized since the opening days of his administration: measurable results. Too often foreign assistance efforts lack clearly specified goals, objectives, and timelines. As a result, the efforts of various donors are poorly coordinated, focus is lost, and progress stalls. Over time donor attention shifts elsewhere, leaving too little of lasting value accomplished.

For this reason, the United States has put strong emphasis on measurable results in the context of the international community's engagement with Haiti. The ICF contains a good outline of goals and timelines. The next step is to operationalize concrete goals and timelines for donors' work in individual sectors, whether that means roadbuilding, police training, expansion of health services, or any other area. Later this week, donors will meet in Port-au-Prince to take the next steps to review the assistance they are providing and further develop the framework for coordinating their efforts and monitoring progress. It is important that we evaluate progress regularly to guarantee donors as well as the government are taking the necessary steps to quickly implement projects.

I would like to say a few words about the special role that the Treasury Department has to play in supporting economic growth in Haiti. Treasury's Office of Technical Assistance works with countries throughout the world to provide expert training on budgetary procedures, tax administration, financial institutions and financial crimes. Treasury has sent three technical assistance teams to Haiti over the past four months to identify steps that can be taken to strengthen tax administration, budget management, and financial crimes. Treasury currently has a team in Port-au-Prince working with the Haitian Central Bank to strengthen financial crimes law enforcement.

Our Technical Assistance program reflects the importance we attach to technical training, consultation, and international collaboration to build local capacity, which is crucial in creating an environment for dynamic growth. I understand that Florida Association for Volunteer Action in the Caribbean and the Americas (FAVACA) also shares this mission and look forward to hearing more from their representatives here today.

The Role of the Private Sector

In that spirit, let me now move on to the role of the private sector in laying the basis for a better future in Haiti. Official aid alone cannot create the jobs and sustainable economic growth that is so desperately needed to raise living standards and lift more Haitians out of poverty. A vibrant private sector--particularly the growth of small businesses--is central to these goals. Developing that vibrant private sector requires the right economic policies by the government--policies that promote private investment and encourage entrepreneurs--as well as the technological and business expertise of businesspeople inside and outside of Haiti.

Based on what I have seen to date, I think that the Haitian government understands the importance of sound economic policies to encourage the private sector. Last month, I had the opportunity to visit Haiti and meet with the Prime Minister, various government officials, and business community leaders. We talked at length about the role of the private sector in Haiti's future and the role that the government plays in creating a regulatory and economic environment which businesses can thrive.

The government has demonstrated its intentions through its actions. I already mentioned the fiscal and monetary restraint displayed by the new authorities upon coming to office. With the assistance of the IMF, the government has defined a

strategy for containing inflation, maintaining fiscal responsibility, increasing transparency, and improving governance. The government showed leadership in the crafting of the ICF and in its commitment to put forward $127 million meet critical needs, including roads, improving electrical distribution, strengthening institutional capacity and increasing security as part of that development plan.

Government officials have also opened the door to the private sector and have begun real dialogue. Last month, Haitian Ministers participated in a private sector event on the margins of the donors conference where they highlighted the important role of the private sector in their growth strategy and outlined their plans to introduce business-friendly initiatives, such as one-stop shops and free trade zones.

To be sure, there is a long way to go. An estimated 95% of private employment is in the informal sector. There are numerous obstacles to business creation and expansion to overcome. But I believe the Haitian authorities want to take the actions needed to create an enabling environment for growth. The private sector has an important role to play in helping the government identify those actions.

In addition to sharing views on the needs of the private sector with the government, the Haitian Diaspora also has an important role as a source of financing and technological know-how. An estimated $1 billion in remittances flowed to Haiti in 2003, roughly equal to 30% of GDP. In addition to meeting basic needs, these funds have the potential to be used to help start new businesses or allow families to keep their children in school. I would encourage you in the Diaspora and in the business community to continue to look forward innovative ways in which remittance flows can be channeled into productive investments that provide for higher standards of living in the future.

I should note that in recognition of the importance of remittance flows, the Bush Administration has launched a global effort to reduce the cost of sending remittances and increase the availability of remittance services. At the Summit of the Americas held in Monterrey, Mexico, earlier this year, President Bush secured agreement among the Hemisphere's leaders to implement the steps needed to cut the average cost of sending remittances in the region in half by 2008. Haiti is in a position to benefit enormously from this initiative. Despite the large volume of flows to Haiti, the cost of sending remittances to Haiti remains high--the IDB estimated the average cost at 8.8% of the amount transferred, which is among the higher costs in the region.

Financial support alone is not enough to build viable businesses. The Haitian private sector needs to cultivate the technical skills for expanding and creating jobs. The technological and business expertise of many of you in this audience--and others like you--is a vital ingredient in this process. It is evident that the Haitian Diaspora also has a wealth of expertise that can be shared. I know that you will continue to build bridges with the Haitian business community to develop new business ventures that transform Haiti's potential into reality.

One area of opportunity is the export sector. Haiti's exports began to pick up in 2003, increasing by 21%, after a three-year decline. However, the value of imports in Haiti was about three and a half times larger than exports in 2003, and Haitian exporting activity remains low when compared to its neighbors. Exports from Haiti are about 1/20th of that of its neighbor, the Dominican Republic. Pursuing new markets opportunities and developing strategies to capitalize on Haiti's comparative advantages--namely its proximity to large markets like the United State and lower labor and operational costs--are essential steps to building up the export sector.

Conclusion

The Bush Administration will continue to work with the Haitian government, other bilateral donors, and the international financial institutions to lay the foundation for higher economic growth and poverty reduction in Haiti. I hope that each of you will also continue your commitment to Haiti and work with the Haitian community to set timelines, measure results, and encourage the vibrant private sector that is critical

for Haiti's future success.

Thank you again for your participation in this event, and I would welcome your thoughts, ideas, and questions.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 23, 2004
js-1869

Testimony of Stuart A. Levey, Under Secretary Terrorism and Financial Intelligence

Chairman Oxley, Congressman Frank and Members of the Committee, thank you for inviting me to testify before you today about our efforts to combat terrorist financing. I am pleased that my first time testifying as Under Secretary for the new Office of Terrorism and Financial Intelligence is on this important subject.

There is little need to underscore the importance of our campaign against terrorist financing, especially before this audience. This Committee has demonstrated its commitment to fighting the financial war against terror and I think would certainly agree, as I do, with the 9/11 Commission's recommendation that "vigorous efforts to track terrorist financing must remain front and center in U.S. counterterrorism efforts." As this statement implies, combating terrorist financing is part of a broader counterterrorism mission. I would therefore first like to describe the U.S. government's overall terrorist financing campaign and how it supports the broader war on terror. I will then describe the vital contribution that the Treasury Department makes to this campaign and how the creation of the Office of Terrorism and Financial Intelligence (TFI) at the Treasury Department will improve our overall performance.

In the course of my testimony, I will address what I believe are the central issues raised by the 9/11 Commission regarding our efforts to combat terrorist financing. Let me say at the outset that I agree with most of the Commission's report as it relates to terrorist financing, and I commend the Commission and its staff for a truly outstanding job analyzing this issue. Most important, I believe the report will us improve our efforts to combat terrorist financing.

A. Terrorist Financing: A Key Front in a Global War on Terror

As the Commission recognized, our terrorist financing campaign must be viewed as one front in a global war on terror. Rather than an end in itself, our attack on terrorist financing is but one means of achieving our broader goal. In the end, the goal is not to stop the money, but to stop the killing. To achieve this goal, we must bring to bear every power available to all relevant government agencies.

Similarly, in attacking terrorist financing, we need to keep open all of our options and choose the course that is most effective in each case. For example, if the most effective strategy with respect to a known financier is to observe him covertly so as to identify and possibly capture the next link in the chain, then we must do that. If the most effective course of action is to designate a financier in order to freeze terrorist-related assets and shut down a source or conduit of terrorist financing, we must pursue that option. As I will discuss, sometimes the different types of actions are complementary. Sometimes they are not and, in those cases, a choice must be made. Our options, however, must be weighed based on the facts of the case. We have an interagency process in place to do just this, where these different options are coordinated to inflict maximum damage to terrorist capabilities. Our goal is not to maximize the number of times that we exercise the tools of a particular agency, but to take the action as a government that will do the most to cripple terrorist organizations.

There are some who question the effectiveness of our strategy to prevent terrorism by attacking the financing that supports it. They note that terrorist attacks themselves cost very little money to carry out – the trivial cost of a suicide belt or similar device – and then leap to the conclusion that our efforts to combat terrorism by attacking terrorist resources are wasted or futile.

The 9/11 Commission wisely rejected this point of view. In the first place, the cost of financing terrorist activity cannot be measured by the cost of a primitive destructive act. The maintenance of those terrorist networks, like al Qaeda, which threaten our national security, is expensive – even if a particular attack does not cost much to carry out. As the 9/11 Commission explained, groups like al Qaeda must spend money for many purposes – to recruit, train, travel, plan operations, and bribe corrupt officials, for example. If we can eliminate or even reduce their sources and conduits of money, we can degrade their ability to do all of these things, and thus can make them less dangerous.

Of course, our attempts to prevent terrorist financing cannot possibly stop all terrorist attacks. Yet the financial networks of terrorist organizations represent vulnerabilities that we can exploit. For example, in appropriate cases, we can immediately strike at the finances of terrorists and their supporters through public designation and the corresponding freezing of terrorist-related assets. We can also quietly investigate and follow money trails to identify and unravel terrorist financing networks. When successful, this method allows us to trace funds "upstream" - to identify terrorist donors and facilitators - and "downstream" - to target terrorist operatives and cells. In addition to these strategies, we can also simultaneously increase transparency and accountability measures that force terrorists to raise, move and store money in riskier and costlier ways, thereby improving our ability to disrupt them.

B. The Interagency Character of Our Campaign Against Terrorist

FinancingOur campaign against terrorist financing is, and must continue to be, an interagency effort, relying on cooperation across the U.S. government. The resources, authorities and expertise of all the relevant agencies cannot and should not be amalgamated in one Department. We need to draw on the full range of weapons in our arsenal - from intelligence activities to diplomatic pressure, from regulatory actions and administrative sanctions to criminal prosecutions - without concern for "turf" or the reputation of a particular agency.

The interagency team that has applied itself to this issue since 9/11 is truly extraordinary. My former home, the Department of Justice (DOJ) and the FBI, for example, have done heroic work to transform themselves to best tackle the terrorist financing problem. Law enforcement is a primary weapon on the domestic front, and the powerful, public effect of successful prosecutions is simply unrivaled. The FBI's financial investigators, coordinated out of the Terrorism Financing Operations Section (TFOS) created by Director Mueller after 9/11 here in Washington, have shown dedication and resourcefulness, marshaling the shared resources of law enforcement through Joint Terrorism Task Forces (JTTF's) across the country, integrating intelligence through unprecedented cooperation with the CIA, and building successful cases that would not have been thought viable a mere four years ago. Bringing these cases to court are talented assistant U.S. attorneys across the country, working under the guidance of a small group of experienced prosecutors at DOJ's Counter-Terrorism Section (CTS) under the leadership of my co-panelist here today, Barry Sabin. Over the past two months, the public has received dramatic reminders of this group's effectiveness, with the indictments of the Holy Land Foundation's leadership echelon and the convictions of Abdulrahman Alamoudi and the Elashi brothers.

The Civil Division of the Department of Justice also plays a key but often unnoticed role in the overall effort. A team of premier lawyers from the Civil Division and the Department of the Treasury has successfully defended every administrative action that Treasury has taken in the terrorist financing campaign against a wide range of constitutional challenges. Congress has given the Treasury Department some very robust powers, such as the ability to block suspected terrorist-related assets, even pending investigation. We have used these powers judiciously, as the courts have affirmed in rejecting legal challenges to these authorities and our use of them. Working together with the Civil Division, the Treasury Department has prevailed in the defense of lawsuits brought by three U.S.-based charities challenging their designation as Specially Designated Global Terrorists pursuant to E.O. 13224. The charities asserted that the Treasury Department, including the Office of Foreign Assets Control (OFAC), had exceeded its authority under the International Emergency Economic Powers Act and violated various constitutional guarantees. In addition, the charities brought an Administrative Procedure Act challenge to the type and quantum of evidence on which Treasury relied in making the designations. Courts of Appeals in the District of Columbia and the Seventh Circuit upheld the legality of Treasury's actions. Holy Land Foundation for Relief & Development v.

Ashcroft, No. 02-5307, 2003 WL 21414301 (D.C. June 20, 2003); Global Relief Foundation, Inc. v. O'Neill, 315 F.3d 748 (7th Cir. 2002); Benevolence Intern. Foundation, Inc. v. Ashcroft, 200 F. Supp. 2d 935 (N.D. Ill. 2002).

Other law enforcement agencies, including Treasury's premier financial investigators in the Criminal Investigation Division of the IRS, have contributed to these efforts, untangling intricate money laundering and tax evasion schemes implicated in terrorist financing investigations to build cases for prosecution. U.S. Immigration and Customs Enforcement (ICE) at the Department of Homeland Security also plays a critical role in terrorist financing cases, working in close collaboration with the FBI. In an excellent example of information sharing between federal law enforcement agencies, ICE vets all of its terrorist financing leads through the FBI pursuant to a Memorandum of Agreement between DOJ and DHS. When an ICE investigation has a nexus to terrorism or terrorist financing, the investigating ICE field office is instructed to contact the appropriate FBI field office to arrange for a smooth transition of the investigation to the FBI-led JTTF. ICE special agents enhance many JTTF investigations by providing information and intelligence, language capabilities, and legal and investigative expertise. ICE and the FBI also established a Joint Vetting Unit staffed by senior personnel from each agency to identify investigations with a potential nexus to terrorist financing. Thus, the FBI and DOJ are immediately aware of all ICE cases that relate to terrorist financing. ICE also does important investigative work in such areas as bulk cash smuggling, unlicensed money remitters, and money laundering through insurance and other non-traditional financial mechanisms.

Other departments and agencies bring expertise, authorities and resources to the campaign against terrorist financing. When it comes to diplomatic efforts, the State Department is of course at the forefront. Since 9/11, the State Department has built a worldwide coalition against terrorist financing – a monumental achievement – and endeavors every day to strengthen it. And, in the overseas intelligence arena, the CIA and its intelligence partners have also reconstituted themselves since 9/11 in ways that are critical to the overall effort but which, in many respects, cannot be discussed in this setting. Our greatest accomplishments to date have all been collaborative efforts, and our success in the future will depend on the strength of our interagency communication, cooperation and collaboration.

C. The Office of Terrorism and Financial Intelligence -- Enhancing Treasury's Contribution

The Congress and the President have given the Treasury Department the responsibility to safeguard the integrity of the U.S. and international financial systems from abuse by terrorists, rogue states, money launderers, and criminals. Treasury – as the United States' Finance Ministry – is well situated to accomplish this mission given its role in both the domestic and international financial systems. Treasury has unique relationships in the international community, including with Finance Ministries, Central Banks, financial intelligence units, and international financial institutions, as well as with the private sector.

To safeguard the financial systems both at home and abroad, the Treasury Department draws upon several capabilities:

- *Sanctions and Administrative Powers*: Treasury wields a broad range of powerful economic sanctions and administrative powers to attack various forms of illicit finance, including E.O. 13224 issued under the International Economic Emergency Powers Act (IEEPA). Treasury's OFAC administers and enforces the various economic sanctions and restrictions imposed under the Secretary's IEEPA authority.
- *Financial Regulation and Supervision:* Treasury, through the Financial Crimes Enforcement Network (FinCEN), administers the Bank Secrecy Act (BSA) and issues and enforces anti-money laundering /counter-terrorist financing regulations. Treasury further maintains close contact with the federal financial supervisors – including the Treasury Department's Office of the Comptroller of the Currency and Office of Thrift Supervision – with the goal of ensuring that these regulations are being implemented consistently throughout the financial sectors.
- *International Initiatives:* Treasury is part of and has access to an extensive international network of Finance Ministries and Finance Ministry-related bodies such as the Financial Action Task Force (FATF) and various FATF-Style Regional Bodies, the International Monetary Fund (IMF), the World

Bank, the G7, and various regional multilateral development banks. In addition, FinCEN is the critical facilitator for the international relationships among financial intelligence units organized through the Egmont Group.

- *Private Sector Outreach:* As a result of our traditional role in safeguarding the financial system, Treasury has developed a unique partnership with the private sector. Through such outreach programs as the BSA Advisory Group (BSAAG) and other regulatory and educational seminars and programs, Treasury maintains a close relationship with U.S. financial institutions to ensure a smooth exchange of information related to money laundering and terrorist financing. FinCEN administers Section 314 of the U.S.A. PATRIOT Act (Patriot Act), which mandates enhanced information sharing between the government and the financial sector.
- *Law Enforcement and Law Enforcement Support*: Treasury combats various forms of financial crime through the direct law enforcement actions of IRS-CI and the law enforcement support provided by FinCEN and Treasury's regulatory authorities.

These assets place the Treasury Department at the epicenter of the forces arrayed against terrorist financing. Since the September 11th attacks, Treasury has diligently applied these assets as part of a comprehensive campaign against terrorist financing. However, until just recently, Treasury's structure did not match its mission in combating terrorist financing as a distinct priority. At the same time that the Commission was preparing the release of its final report, the Treasury Department was preparing a new office structure to improve its ability to combat terrorist financing. The creation of the Office of Terrorism and Financial Intelligence (TFI) at the Treasury Department will enable the Department to bring all of its assets to bear more effectively than it ever has before and to play the leadership role that it should play in battling terrorist financing. The fight against terrorism financing will be a long one, and TFI is structured to manage all of Treasury's resources, authorities and expertise to attack terrorist financing over the long term.

One key function of TFI is to assemble, integrate and analyze intelligence. The war on terror remains a war of information, and TFI's Office of Intelligence and Analysis (OIA) is helping us meet this challenge. OIA will integrate, for the first time, all of the Department's information and intelligence streams, including BSA data at FinCEN, OFAC targeting analysis and sanctions enforcement data, and all intelligence flowing into the Department from the intelligence community. Frankly, this is an area where significant improvement is needed because, prior to the creation of OIA, these data were generally kept in separate "stovepiped" channels. OIA ensures that appropriate security and privacy protections are implemented to safeguard data and that these data streams are reviewed, synthesized, and presented to policymakers for appropriate action.

TFI also includes the Office of Terrorist Financing and Financial Crimes (OTF), which is the policy and enforcement apparatus for the Department on terrorist financing, money laundering, financial crime, and sanctions issues. Building on earlier Treasury efforts, OTF integrates the important functions of OFAC and FinCEN with other components of the Department. OTF represents the United States at international bodies dedicated to fighting terrorist financing and financial crime, such as the FATF, and will increase our other international efforts in this field. Domestically, OTF will continue to develop and implement strategies against money laundering and other financial crimes. For example, OTF is working closely with FinCEN, which has the responsibility to effectively enforce the BSA and related provisions of the Patriot Act. OTF is also increasing our interaction with federal law enforcement and works closely with the criminal investigators at the IRS to deal with emerging domestic and international financial crimes of concern.

Both the intelligence and operational functions are under my direction, and it is my responsibility to ensure that they complement and support each other's missions. I believe that, if I do my job well, TFI will significantly enhance Treasury's contribution to our government's campaign against terrorist financing. I look forward to working with this Committee to achieve that goal.

D. Our Anti-Money Laundering Regime is Critically Important, but Cannot Alone Stop or Defeat Terrorist Financing

As I indicated earlier, I agree with the Commission's key recommendation that "[v]igorous efforts to track terrorist financing must remain front and center in U.S. counterterrorism efforts." The simple fact remains that the money trail generally

does not lie. As we have developed, analyzed, and shared financial intelligence throughout the government, we have refined the way in which we can use money trails to identify, locate, and arrest or capture terrorists and their networks. Studying money trails can also help us understand how terrorists exploit vulnerabilities in our financial systems and take advantage of regulatory weaknesses. This, in turn, permits us to address these vulnerabilities through improved regulatory guidance and by informing private sector institutions of vulnerabilities in their systems.

In order to track money trails of any kind, you need financial information. Much of this information is obtained overtly, through laws promoting financial transparency like the BSA. The key question before us is whether the systems we have implemented to ensure financial transparency – most of which were aimed at money laundering – are sufficient to provide the federal government with the information it needs to "vigorously track terrorist financing."

Our approach to obtaining the necessary financial information to combat terrorist financing has been forged by nearly twenty years of experience in combating money laundering. But there are important and fundamental differences between the financing of terrorism and money laundering, and by relying exclusively on the same methods and tools, we may inhibit our ability to succeed. Treasury, through FinCEN, administers the BSA, which is principally aimed at achieving the appropriate level of financial transparency to detect and prevent money laundering. With money laundering, investigators look through a telescope trying to detect the movement of large amounts of cash. With terrorist financing, investigators need a microscope in order to identify and track the movement of relatively small amounts of often "clean" money supporting an evil purpose.

We have begun the effort to study whether we can devise tools or systems aimed more particularly at terrorist financing. I look forward to working together with this Committee on this important issue. As this Committee knows well, one critically important tool against both money laundering and terrorist financing was provided by Section 314 of the Patriot Act, which mandates the sharing of information with and among the financial sector, that is, both vertically (between the government and the industry) and horizontally (providing a safe harbor that allows industry members to share with each other). Treasury has implemented this section by creating a "pointer" system for law enforcement. This system gives law enforcement, in the right case, the ability to work with FinCEN to transmit names of persons of interest to the financial sector to determine whether those institutions have any relevant transaction or account information. The industry reports back only when it has information, and then law enforcement follows up with the institution with appropriate process. The system implemented by FinCEN has been successful, and law enforcement has advised that it has been a valuable tool. But this system is only a first step when it comes to information sharing.

We should endeavor to develop better processes for sharing information with the financial sector. The financial industry is eager to help – indeed, it has been very helpful already. We must figure out ways to effectively and appropriately share relevant information with the financial sector to better equip it to generate financial information that will help us identify terrorist financing. This will not be an easy task. Much of the information relevant to terrorist financing is classified. Moreover, law enforcement is correctly reticent about sharing information that could compromise an investigation. Finally, we need to be sensitive to the privacy and reputational interests of our citizens and ensure that appropriate controls are in place to safeguard information.

It is also important to remember that the movement of money in the 21st century knows no borders. Terrorism – particularly the type of terrorism we are dealing with since 9/11 – has global reach. The United States is leading the global effort to increase financial transparency, and rules guaranteeing a certain level of transparency are absolutely required if we are to be effective at tracking terrorist financing. Section 311 of the Patriot Act allows us to protect our financial systems from illicit funds emanating from jurisdictions that do not have such rules. This provision provides the authority to prevent jurisdictions and foreign financial institutions found to be of "primary money laundering concern" from doing business with the United States. Just this past May, the Treasury Department designated the Commercial Bank of Syria (CBS), based on concerns relating to financial transparency, and problems we observed with that institution, including terrorist financing. Pursuant to this designation, we have issued a proposed rule that, when issued in final form, will oblige U.S. financial institutions to sever all correspondent relations with CBS. The Commercial Bank of Syria will either take effective steps to

address our concerns, or we will cut it off from our financial system. Actions of this type will help cause jurisdictions and institutions to adopt real reforms that impose an acceptable degree of financial transparency, and will help protect the integrity of our financial system in the meantime. As Under Secretary of TFI, I will aggressively apply Section 311 when we have reason to believe that our financial system is being threatened by terrorist financing or other criminal networks.

E. Using Designations More Effectively

I think I have made clear my view that those of us engaged in the financial war against terrorism should, in every instance, wield whatever tool is best able to advance the overall mission to stop terrorism. Acting in accordance with that principle, however, requires an accurate understanding of the power of each of the relevant tools. In that regard, I would like to discuss the value of the public actions the Treasury Department can take – particularly public designations. The 9/11 Commission states that "public designation of terrorist financiers and organizations is still part of the fight, but it is not the primary weapon. Designations are instead a form of diplomacy, as governments join together to identify named individuals and groups as terrorists. They also prevent open fundraising." While I agree with the first quoted sentence, I think in this particular passage, the 9/11 Commission does not give enough credit to the potential power of public designations. In addition to being a form of diplomacy and stopping open fundraising, if used properly, designations can be valuable by:

1. shutting down the pipeline through which designated parties raise and move money;
2. informing third parties, who may be unwittingly financing terrorist activity, of their association with supporters of terrorism;
3. deterring non-designated parties, who might otherwise be willing to finance terrorist activity; and
4. forcing terrorists to use potentially more costly, less efficient and/or less reliable means of financing.

These benefits of designation cannot be measured by simply totaling the amount of terrorist-related assets frozen. Terrorist-related accounts are not pools of water awaiting discovery as much as they are rivers, with funds constantly flowing in and out. By freezing accounts, we dam that river, thus not only capturing whatever water happens to be in the river at that moment but, more importantly, also ensuring that this individual or organization can never in the future act as a conduit of funds to terrorists. Indeed, if fully implemented, a designation excommunicates supporters of terrorism from the formal financial system, incapacitating them or driving them to more expensive, more cumbersome, and riskier channels.

I say "if fully implemented" because, as the 9/11 Commission recognized, implementation is vital in this context, but not at all assured. The great majority of terrorist financiers and facilitators operate and store their money overseas. For designations to have a maximum impact, we must persuade other nations to take action alongside us. This is not a simple task. In some cases there is a failure of will, and in others there are insufficient means to take administrative action. In either case, we must continue to persuade, cajole, or provide needed technical assistance to make sure that our designations are more than just words on paper. Over the past three years, the State Department has labored tirelessly in this cause, and its persistent work has yielded results: dozens of countries have joined us in submitting over 285 al Qaeda-linked targets for designation under the United Nations; 87 countries in every region of the world have either adopted new laws and regulations to fight terrorist financing or are in the process of doing so; and 20 different U.S. government offices and agencies have provided technical assistance and training to help front-line states develop counter-terrorist financing and anti-money laundering regimes. TFI is currently assisting foreign states to make designations more effective through the development of: intelligence-driven designation protocols; notification, freezing, seizing and reporting protocols for the private sector; and investigative protocols for following leads stemming from frozen accounts and transactions.

We can also improve the effectiveness of designations by focusing on key financial targets. We cannot afford to expend valuable resources and political capital on designations that have little or no practical effect in interdicting terrorist funding or deterring those who would otherwise support terrorism. In this sense, the number of designations issued, like the amount of terrorist-related assets frozen, is a

potentially misleading metric, because that number says nothing about whether a designation has any real impact. Designations are most disruptive and effective when applied against terrorist financiers, facilitators, and donors whose financial support is critical to terrorist operations. Such designations also have the greatest deterrent effect among other potential terrorist supporters.

In assessing the potential value of designations, it is also important to realize that designations are also not necessarily applied at the expense of other actions. The administrative nature of designations and the congressionally-authorized use of classified information to support them allow us to shut down terrorist financing sources and conduits quickly when other options may not be ripe for action. In these instances, we can continue to pursue parallel criminal investigations and prosecutions.

For example, just two months after the President signed Executive Order 13224, the Treasury Department froze the assets of three large Islamic charities associated with terrorist financing activity in the U.S.: the Holy Land Foundation (HLF), the Global Relief Foundation (GRF), and the Benevolence International Foundation (BIF). These actions ensured that no more money would flow from these organizations to al Qaeda or other terrorist groups. The assets of these organizations were instantly locked in place. Thereafter, the Department of Justice successfully prosecuted BIF's chief executive officer, Enaam Aranout. In the case of HLF, the Department of Justice has also indicted the organization and its leadership on terrorist financing-related charges and is now seeking to forfeit the assets that Treasury blocked pursuant to designation. This combination of designation and law enforcement action created an optimal outcome. First, the more nimble administrative standard for designations allowed Treasury to intercede swiftly and shut down terrorist financing that was occurring through HLF accounts, thereby potentially preventing future terrorist acts. Second, the Justice Department was able to continue its criminal investigations of terrorist financing activity and carefully build its cases for criminal prosecution under the more restrictive processes and evidentiary standard that attend our criminal justice system. Third, Treasury's designation prevented the flight of terrorist-related assets out of the United States, securing these assets for constructive use. These effects demonstrate how terrorist financing designations can facilitate and complement other actions by the government.

F. The Need for International Cooperation and Engagement

As I have mentioned above, our terrorist financing campaign depends on international cooperation. The terrorist threats that we face and the capital provided to fuel terrorist activity emanate principally from abroad. Attacking, preventing and protecting against these threats require international action. Treasury has worked together with the State Department and others in the interagency community to enlist international support in a global campaign against terrorist financing.

Building on Treasury's relationships with Finance Ministries around the world, we have developed a strategy to globalize this campaign that includes: (i) establishing or improving international standards to address identified vulnerabilities; (ii) ensuring global compliance with these standards; (iii) improving global capabilities to identify, freeze and investigate terrorist-related assets and accounts; (iv) addressing financing mechanisms of particular concern, and (v) facilitating the sharing of information.

Together with our counterparts in the FATF, Treasury has covered tremendous ground since 9/11 in developing international standards to combat terrorist financing, building from the international community's experience in combating money laundering. These standards have mobilized the international community to take action on important terrorist financing issues such as: freezing terrorist-related assets; regulating and monitoring alternative remittance systems; ensuring accurate and meaningful originator information on cross-border wire transfers, and protecting non-profit organizations from terrorist abuse. Treasury is also engaging the FATF to pursue the risk of terrorist financing through cash couriers. The recent decision by the IMF and World Bank to make country compliance with the FATF standards a part of their regular surveillance of global financial sectors is an important step forward in giving real meaning to these standards. These efforts have produced considerable results, but more can and should be done. TFI will continue to engage the international community to target specific issues and jurisdictions of concern, and to encourage effective implementation of standards to combat terrorist

financing.

Conclusion

In preparing for my new position, I have repeatedly confronted questions about our effectiveness in the campaign against terrorist financing. Put simply, are we making progress? How can we know if we are achieving our objectives? How do we measure success?

These are important questions, and difficult ones. Al Qaeda does not release financial statements, and we will never know precisely how much money is flowing to a terrorist group in a given year or how much money intended for terrorists never reached their hands due to our efforts. We therefore often find ourselves discussing proxies for these ultimate questions: how many donors and facilitators are captured or behind bars; how much money has been frozen or seized; how many countries are joining us in freezing assets or upgrading their laws to make it harder to move money illegally. Each of these benchmarks points to only one aspect of the problem, though, and imperfectly at that.

More revealing, to my mind, is intelligence that reflects the ease or difficulty with which terrorists are able to raise, move, and store money. If reporting suggests that fewer and fewer donors are willing to risk sending money to terrorist groups – that is a sign of success. If we see that a terrorist group is resorting to riskier and more cumbersome ways of moving money – that is also a sign of success. And if we receive intelligence that terrorist groups like al Qaeda or HAMAS are desperate for money, that is the best indicator we have that we are making a real difference.

The information available to us indicates that there are some encouraging answers to these questions. Not surprisingly, the information also suggests that we still have a lot of work to do. I think it is fair to say that, while we must prepare for a long term campaign against terrorist financing, our policies are beginning to achieve results, and we are headed in the right direction.

I would be happy to answer any questions that you may have.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 23, 2004
js-1870

Under Secretary Taylor's Remarks on Latin American Expansion

The Latin American Expansion - Benefits for the United States John B. Taylor Under Secretary of Treasury for International Affairs Meeting with Leaders of the South Florida Business Community Organized by Florida FTAA, Inc. Biltmore Hotel Coral Gables, Florida August 23, 2004

Thank you very much to Jorge Arrizurieta for inviting me to speak to this distinguished group. It is always a pleasure to talk to businesspeople who are involved in Latin America, since it is the private sector that is the engine for creating jobs, raising incomes, and reducing poverty in this region and around the world.

Stronger economies in Latin America benefit not only the people of the region, but also the people of Florida and all citizens of the United States. Growing economies in our Hemisphere create jobs in the United States by increasing demand for U.S. exports: last year, exports to Latin America represented about one-seventh of total U.S. exports and nearly one-half of Florida's exports. More vibrant economies and rising living standards in Latin America also reduce the incentives for illegal migration, strengthen democracy, and reinforce popular support for market-oriented policies that create opportunity and enhance economic freedom. In addition to reflecting American values, stronger democracies in Latin America are better allies in the war on terror, the fight against international narcotics trafficking, and initiatives to combat money laundering and terrorist financing. The cooperation of America's closest neighbors is essential to our success in these efforts.

Today I would like to take the opportunity to highlight the steps that the Bush Administration has taken and continues to pursue to support economic growth in the region, open up further opportunities for international trade, and work with the governments in the hemisphere to put in place sound economic policies that promote entrepreneurialism and investment. I am pleased to say that we are already beginning to see the beneficial effects of those policies in the form of stronger economic growth in the region.

Free Trade Area of the Americas (FTAA) and our Trade and Investment Agenda

Since this is the FTAA Roundtable, let me begin with the FTAA and our trade agenda. Trade and investment are critical to providing opportunities for job creation and economic growth. The Bush Administration has been committed to strengthening the global trading system by re-starting the WTO Doha negotiations. We are very pleased with the outcome of the recent WTO Ministerial and optimistic that we are again on the right track in these negotiations. At the same time, we have pursued free trade and improved trade and investment rules through bilateral and regional free trade agreements.

Nowhere has our negotiating agenda been fuller than in Latin America. In addition to pursuing the 34-country FTAA, we have concluded an FTA with five Central American countries and the Dominican Republic. Panama talks are progressing nicely, and we are hopeful that our dialogue with Andean countries will deepen and accelerate now that both sides have tabled proposals in most areas. U.S. trade turnover with these ten countries was over $50 billion in 2003, and the potential for growth is substantial.

Of course, the capstone of our efforts to integrate and strengthen the economies of the Hemisphere would be a successful conclusion of the Free Trade Area of the

Americas. We are hopeful that the spirit of the recent success in Geneva will carry over to the FTAA negotiations. As you know the FTAA negotiators have been working to translate the decisions reached at the November 2003 Miami Ministerial meeting into instructions for negotiators that will lead to the resumption of the FTAA talks. The Ministers agreed that there would be two negotiating tracks in the FTAA and the senior level Trade Negotiations Committee is charged with developing general guidance for the common set of obligations and procedures for negotiation of higher level plurilateral agreements. We are pleased with the work that we were able to do with Foreign Minister Amorim and his team in Geneva on the Doha Agenda. They played a constructive role in that process. The U.S. co-chair of the FTAA process will continue to consult with the Brasilian co-chair and the other countries to determine the best way forward. As the FTAA is a negotiation among 34 participants, it is hard to predict how the decisions taken in Geneva will impact the FTAA negotiations. Failure to resume negotiations toward a high standard FTAA would be a great loss for the entire region. We are hopeful that negotiations will resume soon and that the vision of economically integrating the entire Hemisphere will be realized.

At the same time, we continue to move ahead on our bilateral and regional negotiating agenda. It is worth noting that our trade agreements broadly encourage change in the economies of our partners that will set them on course for faster development and increased prosperity, as has been the case with Mexico. Beyond removing barriers to trade, these agreements provide for increased regulatory transparency, investor protections, effective dispute settlement, and customs reform and automation. They were developed through intensive and public engagement by civil society and industry groups that buttress democracy in these nations. For example, at the last round of our Andean FTA negotiations, about 440 negotiators from the Andean countries participated, and about 600 businesspeople, and some legislators, participated in parallel activities. This is tremendous engagement and a great opportunity for dialogue and education.

In addition, the United States instituted a parallel trade capacity building process that accompanies all of our FTA negotiations that provides our partner countries with assistance in preparing for the negotiating process (such as compilation and analysis of statistics, negotiator training and making available lap top computers), as well as assistance with anticipated trade adjustment needs. A trade capacity working group was institutionalized under the CAFTA agreement and will continue to coordinate assistance.

The Bush Administration's Growth Agenda for Latin America

Of course, trade is only one element of a broad and active agenda in the region. Since coming into office, the Bush Administration has worked through a variety of channels to bolster economic growth in the region, as well as contain and prevent the disruptive effects of financial crises. Our approach is built on the idea of providing strong support to countries that are pursuing sound economic policies. Without sound policies on the part of the country itself, no amount of international assistance can yield successful results.

Let me give two examples of how U.S. efforts to support countries with good policies were critical to helping the region through the economic difficulties of 2002 and laying the basis for the accelerating recovery that the region is currently experiencing. In August 2002, the United States supported a $30 billion IMF program for Brazil. This support was instrumental in helping Brazil to overcome severe pre-election financial market volatility--which had pummeled Brazil's currency and pushed risk spreads to near 2,400 basis points above U.S. Treasuries. It enabled President Lula's administration to take office and have the room to develop a strong policy program. Likewise, our actions with respect to Colombia provide a good example of successful crisis prevention through a combination of effective domestic policies and strong U.S. support for engagement by the international financial institutions. With risk spreads on Colombian bonds rising sharply during fall 2002, President Uribe took bold measures to restore market confidence, passing important tax, pension, and labor market reforms and defining a strong economic program for the future. In turn, the United States supported budgetary assistance by the multilateral development banks and approval of a two-year, $2 billion IMF program--paving the way for Colombia to reaccess international capital markets and to achieve its strongest real GDP growth performance in eight years in 2003.

Understanding financial contagion--the spread of crises from one country to another--and the circumstances under which it is appropriate to respond was an early focus for the administration and is critical to implementing our policy of supporting strong performers. Overreacting to false alarms about contagion can lead to support for countries that are not following strong and sustainable policies. At the same time, it is important to recognize instances where countries are pursuing strong policies but are hit by external shocks that impact their economies. We found that to be the case in Uruguay when the Argentina crisis caused a run on deposits in the Uruguayan banking system. The United States responded by extending a short-term $1.5 billion loan to bolster the government's reserves until additional support from the IMF, World Bank and Inter-American Development Bank could be mobilized. The result was an end to the deposit run, and continued sound government policies have ushered in a renewed period of strong economic growth in Uruguay.

As important as preventing and containing financial crises is for sustaining economic growth, deeper economic reforms aimed at knocking down the impediments to a vibrant private sector are just as critical. Discussions of such issues are a prominent part of our engagement with the countries of the region. Perhaps the best example is the U.S.-Brazil Group for Growth, which was established at the first summit meeting between Presidents Bush and Lula in June 2003. The purpose of the Group is to advance policies for raising economic growth and creating jobs in both countries by focusing on areas such as expanding credit to small businesses, streamlining business registration procedures to make it easier to start a business, and improving public investment. At their meeting in New York in June, Secretary Snow and President Lula discussed the continuing work of the Group in moving forward policies needed to raise productivity growth and improve living standards.

Another important bilateral forum has been the U.S.-Mexico Partnership for Prosperity, which was launched in 2001 with the goal of promoting economic development on both sides of the border with a particular focus on the poorer parts of Mexico. The Partnership activities cut across several agencies from both governments. A major area of focus for the Treasury Department has been on remittances from workers in the United States to their families in Mexico. Work to promote increased competition in the remittances industry and expand access to the formal financial system under the Partnership has helped halve the cost of remittance transfers from the United States to Mexico since 1999, and led to the introduction of a range of new products.

The emphasis on supporting countries that are pursuing responsible policies extends to the Bush Administration's approach to development assistance. The Bush Administration has sought to reorient U.S. development assistance by creating the Millennium Challenge Corporation and (MCC) and its Millennium Challenge Account (MCA). The MCC directs aid funds to countries that invest in people, pursue good governance and rule of law, and promote economic freedom. Congress has appropriated $1 billion to the MCA in fiscal year 2004 and the Bush Administration is requesting $2.5 billion in 2005, ramping up to $5 billion by 2006. Of the sixteen countries selected by the Board of Directors eligible to submit proposals, three--Bolivia, Nicaragua and Honduras--are from Latin America. These countries are now developing their program proposals. The MCC will then evaluate those proposals and select proposals that contain quality programs with a strong likelihood of success and measurable results.

The MCA is one of several specific initiatives that the administration has advanced to boost economic growth in the region. At the Summit of the Americas--a meeting of the hemisphere's leaders held in Monterrey in January 2004--President Bush secured international agreement on several U.S.-proposed initiatives to raise living standards in the region. Leaders at the Summit agreed to take the steps necessary to cut the time needed to start a business and to triple credit to small businesses by 2007 with the help of the IDB. Leaders also agreed to work to halve the average cost of remittance transfers in the region by 2008--an extremely significant commitment, given the growing importance of remittance flows as a source of funds that could support economic development, new businesses, alleviate entrenched poverty and provide opportunities for children to stay in school and build the human capital of the region. Annual remittance flows are five times annual official development assistance and are a large share of total GDP for many countries.

Seeing Results: Stronger Economic Growth in Latin America

I am pleased to say that we are already seeing the results of the Bush Administration's global economic leadership in both Latin America and the rest of the world. The global economy as a whole is the strongest it has been in decades, and Latin America has been home to some of the most significant economic improvements over the past year. Recent months have provided further evidence that the economic recovery in the region is gaining more strength after the difficulties of 2002. Real GDP in the first quarter of 2004 grew at an annual rate of more than 5 percent in Brazil, Mexico, Argentina, Peru, Chile, and Uruguay. Market forecasters are now estimating that regional GDP growth will exceed 4½ percent for 2004 as a whole, with growth in most countries expected to outpace 2003 results.

Exports and strengthened external balances are playing a key role in this recovery. Strong performance of exports has helped reverse current account deficits. In 2003 the current account as a share of GDP for the region swung into surplus in 2003 for the first time in 35 years. And exports continue to grow, up 30 percent in Brazil and Peru for the first half of 2004 compared to the same period last year. High commodity prices have played a role in these numbers, but it is striking how much has been driven by increased volumes, pointing to the possibility that enduring structural changes are taking place in Latin America that are orienting these economies toward exploiting the growth potential of their export sectors. This makes further progress on regional trade liberalization--as well as global trade liberalization in the context of the ongoing World Trade Organization talks--all the more important to the region's future prospects.

Better economic policies within Latin America--supported by the United States and the international financial institutions--have underpinned these improvements in economic performance, enabling the countries of the region to take advantage of the opportunities afforded by the global economic recovery. In 2003, six of the region's seven largest economies--Brazil, Mexico, Colombia, Argentina, Chile, and Peru--increased their primary budget surpluses to bring down debt levels and reduced or maintained low inflation. Many countries took advantage of strong bond prices in late-2003 and early-2004 to pre-finance government obligations falling due this year. Central banks have increased their accumulation of foreign reserves to provide a cushion against future market turbulence. The credit rating agencies have recognized these and other policy improvements, upgrading their ratings for Brazil, Chile, Ecuador, and Uruguay during 2003 and 2004.

I would like to highlight the achievements of Brazil as one of the clearest examples of how sound economic management has supported economic growth. Upon taking office, President Lula affirmed his commitment to sound fiscal and monetary policies. In view of concerns about Brazil's debt levels, the Lula administration established an ambitious target for the primary budget surplus aimed at bringing down the debt over time--and then went on to beat the target. The central bank carefully calibrated its monetary policy to keep control of inflation in the wake of the large *real* depreciation in 2002.

Now Brazil is reaping the benefits of these policies. Real interest rates have come down sharply--from about 19 percent in the summer of 2003 to less than 10 percent today. Brazil's economy grew at an annualized rate of about 6 percent in fourth quarter of 2003 and nearly 7 percent in the first quarter of 2004. Monthly economic indicators point to a strong second quarter as well, and Brazil's economy is forecast to grow close to 4 percent for the year as a whole. The currency and external borrowing spreads are relatively stable, and inflation expectations are within the targeted band of 5.5 percent ± 2.5 percent.

The Brazilian authorities are focused on cementing these gains. Last year's reform of the public pension system, this year's vote to limit the increase in the minimum wage, and the continued adherence to its primary surplus target are signs of the government's continued commitment to fiscal responsibility. The central bank's care in setting interest rates, amid occasionally intense political pressure, demonstrates continued adherence to the inflation-targeting regime.

One can cite many examples of such progress throughout the region. In Mexico, tight limits on discretionary government spending have helped the government achieve disciplined fiscal targets, while the Fox administration has also made progress on reforms aimed at putting Mexico's social security system on a more sound financial footing. The Uribe government in Colombia is advancing measures to reduce inflexible government expenditure and streamline the pension system. Peru has stepped up efforts to improve tax administration and fight tax evasion, as

part of its program of strengthening government finances and bring down debt levels. Uruguay has demonstrated real success in its fiscal policy efforts, nearly tripling its public sector primary balance in the first half of this year compared to last year.

Stronger fundamentals and stronger policies have helped the region's financial markets weather concerns about higher global interest rates. Strong U.S. economic data and expectations of interest rate increases led to a rise in Latin American sovereign risk spreads during the spring, with the benchmark the Latin America EMBI increasing from around 525 basis points over U.S. Treasuries at the end of March to a peak of about 700 basis points in early May. The Federal Reserve has since increased overnight interest rates twice, its first interest rate increases in four years. During the same period, the Latin America EMBI spread has fallen back down to about 550 basis points over Treasuries. While no one can predict what will happen in the future, we have not seen the major unwinding scenario that many had feared would accompany the beginning of the monetary tightening cycle in the United States. I think that stronger fundamentals and stronger policies go a long way in explaining why.

Conclusion

Sustaining this positive trend will require continued efforts by Latin American countries to maintain the disciplined macroeconomic policies they have been following during the past two years and to advance the legal, regulatory, and institutional reforms needed to increase long-term economic growth. As those in this room know, there is much to be done to improve the business climate for investment and entrepreneurial activity in Latin America. Governments of the region need to step up their efforts to strengthen the rule of law, fight corruption, streamline regulation, develop infrastructure, improve health and education, and expand access to credit for small businesses.

I remain confident that the United States can play an important and constructive role in helping the region tackle the challenges it faces in terms of sustaining long term growth and raising living standards throughout the hemisphere. Through its policy of working with countries that are implementing good policies and supporting them through the international financial institutions, as well as further opening trade and investment flows in the region and launching innovative initiatives to jumpstart economic growth and development, the Bush Administration has shown its commitment to the region's future.

Thank you and I am happy to take questions.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 23, 2004
js-1871

Treasury Issues Guidance on Qualified Severances Of Trusts

The Treasury Department and Internal Revenue Service issued guidance today addressing the requirements for a "qualified severance" of a trust for purposes of the generation-skipping transfer (GST) tax.

"We are pleased to be able to provide guidance in this complex area of the law," stated Acting Assistant Secretary for Tax Policy Greg Jenner. "This guidance should enable taxpayers to achieve the most efficient and effective use of their GST exemptions consistent with the law."

The proposed regulations implement recent statutory changes that expanded the availability of a qualified severance. The proposed regulations provide guidance concerning the proper procedure, permissible timing, and required reporting of a qualified severance, and the permitted methods of funding the resulting trusts.

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REPORTS

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

[4830-01-p]

DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Parts 1 and 26

[REG-145987-03]

RIN 1545-BC50

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: These proposed regulations provide guidance regarding the qualified severance of a trust for generation-skipping transfer (GST) tax purposes under section 2642(a)(3) of the Internal Revenue Code, which was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The regulations will affect trusts that are subject to the GST tax.

DATES: Written or electronic comments and requests for a public hearing must be received by November 22, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-145987-03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-145987-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS - REG-145987-03).

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

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(d)). 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 October 25, 2004. Comments are specifically requested concerning:

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

The accuracy of the estimated burden associated with the proposed 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 collection of information in this proposed regulation is in §26.2642-6(b). This collection of information is required by the IRS to identify whether a trust is exempt from the GST. This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required in order to have a qualified severance. The respondents are trustees of trusts that are being severed.

Estimated total annual reporting burden: 12,500 hours.

Estimated average annual burden hours per respondent: 30 minutes.

Estimated number of respondents: 25,000.

Estimated annual frequency of responses: 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 26 U.S.C. 6103.

Background

Section 2642(a)(3) was added to the Internal Revenue Code by EGTRRA, Public Law 107-16 (115 Stat. 38 (2001)). Under section 2642(a)(3), if a trust is divided into two or more trusts in a "qualified severance," the resulting trusts will be recognized as separate trusts for GST tax purposes. In many cases, a qualified severance of a trust will facilitate the most efficient and effective use of the transferor's GST tax exemption.

The GST tax exemption is the lifetime exemption applicable in determining the inclusion ratio with respect to the trust, which in turn determines the amount of GST tax imposed on any generation-skipping transfer made from the trust.

Section 2642(a)(3) expands the options for trustees wishing to sever trusts by providing more time to make the severance, providing that severances may occur for more trusts, and providing a uniform system for severance. Section 2642(a)(3) was intended to supercede and replace §26.2654-1(b) of the Generation-Skipping Transfer Tax Regulations, which authorizes the recognition of severed trusts for GST tax purposes in limited situations involving testamentary trusts or inter vivos trusts that are included in the transferor's gross estate for estate tax purposes. That regulation does not apply to irrevocable inter vivos trusts that are not includible in the decedent's gross estate. Further, under that regulation, a severance is recognized only if commenced within a prescribed time period, and only if specifically authorized under the terms of the governing instrument or local law.

Section 2642(a)(3)(B)(i) provides a general rule that a qualified severance is defined as the division of a single trust and the creation of two or more trusts if: (1) the single trust is divided on a fractional basis; and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. Under section 2642(a)(3)(B)(ii), if a trust has an inclusion ratio that is greater than zero and less than one, the trust must be severed in a specified manner that produces one trust that is wholly exempt from GST tax, and one trust that is wholly subject to GST tax. Each of the two new trusts created may be further divided into two or more trusts under section 2642(a)(3)(B)(i). Under section 2642(a)(3)(C), a trustee

may elect to sever a trust in a qualified severance at any time, and the manner in which the qualified severance is to be reported is to be specified by regulation. Section 2642(a)(3) is applicable for severances of trusts occurring after December 31, 2000.

Explanation of Provisions

I. Division on a Fractional Basis

Under section 2642(a)(3), in order to constitute a qualified severance, the single trust must be divided on a fractional basis. Under the proposed regulations, each new trust must receive assets with a value equal to a fraction or percentage of the total value of the trust assets. Thus, for example, the severance of a single trust on the basis that one trust is to be funded with 30% of the trust assets and that the other trust is to be funded with the remaining 70% of the trust assets would satisfy this requirement. Similarly, a severance stated in terms of a fraction of the trust assets such that one trust is to receive, for example, that fraction of the trust assets the numerator of which is $1,500,000 and the denominator of which is the fair market value of the trust assets on a specified date and the second trust is to receive the remaining fraction, would also satisfy this requirement. However, the severance of a trust based on a pecuniary amount (for example, severance of a single trust on the basis that one trust is to be funded with $1,500,000, and the other trust is to be funded with the balance of the trust corpus) would not satisfy this requirement.

The proposed regulations provide that each separate trust need not be funded with a pro rata portion of each asset held by the original trust. Rather, the separate trusts may be funded on a non pro rata basis (that is, where each resulting trust does not receive a pro-rata portion of each asset) provided that funding is based on the total

fair market value of the assets on the date of funding. This avoids the necessity of dividing each and every asset on a fractional basis to fund the severed trusts.

II. New Trusts Must Provide for the Same Succession of Interests

Under section 2642(a)(3)(B)(i)(II), the new trusts created as a result of the qualified severance must provide in the aggregate for the same succession of interests of beneficiaries as provided in the original trust. Under the regulations, the beneficiaries of each separate trust resulting from the severance need not be identical to those of the original trust. In the case of trusts that grant the trustee the discretionary power to make non pro rata distributions to beneficiaries, the separate trusts will be considered to have the same succession of interests of beneficiaries if the terms of the separate trusts are the same as the terms of the original trust, the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651) than the person or persons who held the beneficial interest in the original trust, and the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. This rule for discretionary trusts is intended to facilitate the severance of trusts along family lines.

In this regard, the Treasury Department and the IRS recognize that in many cases involving discretionary trusts, when the members of two or more families are beneficiaries, the parties may desire to divide the trust along family lines so that one trust is established exclusively for the benefit of one family and one trust is established exclusively for the benefit of another family. If the inclusion ratio of the trust is between zero and one, section 2642(a)(3)(B)(ii) would ordinarily, as a practical matter, preclude the division of the trust along family lines because the section requires that the

severance result in one trust with an inclusion ratio of zero and one trust with an inclusion ratio of one. However, under the proposed regulations, a similar result may be accomplished through a series of severances; that is, first a division of the trust based on the inclusion ratio, and then a division of each resulting trust along family lines.

Finally, §26.2601-1(b)(4) of the regulations contains rules for determining when certain actions with respect to a non-chapter 13 trust (a trust that was irrevocable on or before September 25, 1985) will not cause the trust to lose its exempt status. In particular, under §26.2601-1(b)(4)(i)(D)(1), a modification (including a severance) of a non-chapter 13 trust will not cause the trust to be subject to the provisions of chapter 13 if the modification does not (1) shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification or (2) extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Under the proposed regulations, the rules in §26.2601-1(b)(4) will continue to apply to severances (and other actions) with respect to trusts created on or before September 25, 1985. However, the post-2000 severance of a trust created after September 25, 1985, will be governed by section 2642(a)(3) and the applicable regulations.

III. Reporting Requirements

The proposed regulations provide that a qualified severance is to be reported by filing a Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations," or such other form that may be published by the IRS in the future that is specifically designated to be utilized to report qualified severances. When Form 706-GS(T) is

utilized, the filer should write "Qualified Severance" in red at the top of the return and attach a Notice of Qualified Severance to the return that clearly identifies the trust that is being severed and the new trusts created as a result of the severance. The Notice must also provide the inclusion ratio of the trust that was severed and the inclusion ratios of the new trusts resulting from the severance. The return and attached notice must be filed even if the severance does not result in a taxable termination. A transition rule applies in the case of severances occurring before the date of publication of the final regulations.

IV. Income Tax Consequences of Severance under the Proposed Regulations

The proposed regulations provide that a qualified severance will not constitute an exchange of property for other property differing materially either in kind or in extent, for purposes of section 1001, provided that: (1) an applicable state statute or the governing instrument authorizes the trustee to sever the trust; and (2) if the separate trusts created by the severance are funded on a non pro rata basis, as discussed in Section I above, an applicable state statute or the governing instrument authorizes the trustee to fund the separate trusts on a non pro rata basis. If section 1001 does not apply in accordance with this standard, then under section 1015, the basis of the trust assets will be the same after the severance as the basis of those assets before the severance, and under section 1223, the holding periods of the assets distributed to the new trusts will include the holding period of the assets in the original trust.

V. Proposed Effective Date

Section 2642(a)(3) supercedes the regulatory rules contained in §26.2654-1(b). Accordingly, under the proposed regulations, the applicability of §26.2654-1(b) is limited

to severances occurring on or before December 31, 2000. The regulations under section 2642(a)(3), as proposed, apply to severances occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations. In the case of severances occurring after December 31, 2000, and before publication of final regulations, taxpayers may rely on any reasonable interpretation of section 2642(a)(3) as long as reasonable notice concerning the severance and identification of the trusts involved has been given to the IRS.

The regulations under section 1001, as proposed, apply to severances occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations. However, taxpayers may apply the proposed regulations under section 1001 to severances occurring after August 24, 2004 and before publication of 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 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. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the collection of information imposed by this regulation is not significant as reflected in the estimated burden of information collection for, which is 0.5 hours per respondent, and that few trustees are likely to be small entities. 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 business.

Comments and Requests for Public Hearing

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

Drafting Information

The principal author of these proposed regulations is Mayer R. Samuels, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. If you have any questions concerning these proposed regulations, please contact Mayer R. Samuels at (202) 622-3090. 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 26

Estate taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 26 are 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. In §1.1001-1, paragraph (h) is added to read as follows:

§1.1001-1 Computation of gain or loss.

* * * * *

(h) Qualified severances of trusts--(1) In general. A severance of a trust that meets the requirements of §26.2642-6 is not an exchange of property for other property differing materially either in kind or in extent if--

(i) An applicable state statute or the governing instrument authorizes the trustee to sever the trust; and

(ii) If the separate trusts created by the severance are funded on a non pro rata basis as provided in §26.2642-6(b)(3), an applicable state statute or the governing instrument authorizes the trustee to fund the separate trusts on a non pro rata basis.

(2) Effective date. This paragraph (h) applies to severances occurring on or after the date these regulations are published as final regulations in the **Federal Register**. Taxpayers may apply this paragraph (h) to severances occurring on or after August 24, 2004 and before the date these regulations are published as final regulations in the **Federal Register**.

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

Par. 3. The authority citation for part 26 is amended by adding an entry in numerical order to read, in part, as follows:

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

Section 26.2642-6 also issued under 26 U.S.C. 2642. * * *

Par. 4. In §26.2600-1, the table is amended as follows.

1. An entry for §26.2642-6 is added.

2. The entry for §26.2654-1(b) introductory text is revised.

3. An entry for §26.2654-1(c) is added.

The revision and additions read as follows:

<u>§26.2600-1 Table of contents</u>.

* * * * *

<u>§26.2642-6 Qualified severance</u>.

(a) In general.
(b) Requirements for a qualified severance.
(c) Time for making a qualified severance.
(d) Irrevocable trusts.
(e) Examples.
(f) Effective date.
* * * * *

<u>§26.2654-1 Certain trusts treated as separate trusts</u>.

* * * * *
(b) Division of a trust included in the gross estate occurring on or before December 31, 2000.
* * * * *
(c) Qualified severance occurring after December 31, 2000.

Par. 5. Section 26.2642-6 is added to read as follows:

§26.2642-6 Qualified severance

(a) In general. If a trust is severed into two or more trusts, the separate trusts resulting from the severance will be treated as separate trusts for generation-skipping transfer tax purposes only if the severance is a qualified severance. In general, the rules in this section are applicable only for purposes of the generation-skipping transfer tax and are not applicable in determining, for example, whether the severance may result in a gift subject to gift tax, cause the trust to be included in the gross estate of a beneficiary, or result in a realization of gain for purposes of section 1001. See §1.1001-1(h) for rules relating to whether a qualified severance will constitute an exchange of property for other property differing materially either in kind or in extent.

(b) Requirements for a qualified severance. For purposes of this section, a qualified severance is a division of a single trust into two or more trusts that meets each of the following requirements:

(1) The single trust is severed pursuant to the terms of the governing instrument, or pursuant to applicable local law.

(2) The severance is effective under local law.

(3) The single trust is severed on a fractional basis, such that each new trust is funded with a fraction or percentage of the entire trust. For this purpose, the fraction or percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to transferor's unused GST tax exemption, and the denominator of which is the fair market value of the trust assets on the date of severance). The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust would not be a qualified

severance if the trust was divided into two trusts, with one trust to be funded with $1,500,000 and the other trust to be funded with the balance of the original trust assets. For purposes of this paragraph, the separate trusts resulting from the severance may be funded with the appropriate fraction, percentage, or pro rata portion of each asset held by the undivided trust, or on a non pro rata basis. However, if funded on a non pro rata basis, each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of funding.

(4) The terms of the new trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This requirement will be satisfied if the beneficiaries of the separate trusts and the interests of the beneficiaries with respect to the separate trusts, when the separate trusts are viewed collectively, are identical to the beneficiaries and their respective beneficial interests with respect to the original trust before severance. With respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non pro rata basis, this requirement will be satisfied if the terms of each of the separate trusts are the same as the terms of the original trust (even though each permissible distributee of the original trust might be a beneficiary of only one of the separate trusts), the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651) than the person or persons who held the beneficial interest in the original trust, and the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(5) In the case of a severance after GST tax exemption has been allocated to the trust as a result of an allocation, deemed allocation, or automatic allocation pursuant to the rules contained in section 2632, if the trust has an inclusion ratio as defined in §26.2642-1 that is greater than zero and less than one, then the trust may be severed initially only into two trusts. One separate trust must receive that fractional share of the total value of all trust assets as of the date of funding equal to the applicable fraction, as defined in §26.2642-1(b) and (c), with respect to the single trust immediately before the severance. The other separate trust must receive the balance of the trust assets. The trust receiving the fractional share equal to the applicable fraction shall have an inclusion ratio of zero, and the other trust shall have an inclusion ratio of one. If the applicable fraction with respect to the original trust is .50, then with respect to the two equal trusts resulting from the severance, the Trustee may designate which of the resulting trusts will have an inclusion ratio of zero and which will have an inclusion ratio of one. Each separate trust resulting from the severance may be further divided in accordance with the rules of this section.

(6) The severance is reported by filing Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations," or such other form that may be published by the IRS that is specifically designated to be utilized to report qualified severances. When Form 706-GS(T) is utilized, the filer should write "Qualified Severance" in red at the top of the return and attach a Notice of Qualified Severance to the return. The Notice must contain: a statement identifying the trust that is severed, the name of the transferor of the trust, the date of creation, the tax identification number, and the inclusion ratio with respect to the trust before severance; and a statement identifying each of the new trusts

created as a result of the severance, the name and tax identification number of each new trust, the fraction of trust assets received by each new trust, other details explaining the basis for funding each new trust (a fraction of the total fair market value of the assets on the date of funding or a fraction of each asset), and the inclusion ratio of each new trust. The return and attached Notice must be filed by April 15th of the year immediately following the year during which the severance occurred or the last day of the period covered by an extension of time, if an extension of time is granted.

(c) Time for making a qualified severance. A trust may be severed in a qualified severance at any time prior to the termination of the trust. Thus, provided that the separate trusts resulting from the severance continue in existence after the severance, a trust may be severed in a qualified severance either before or after: GST tax exemption has been allocated to the trust; a taxable event has occurred with respect to the trust; or an addition has been made to the trust. A qualified severance is effective at the time the trust is divided into two or more separate trusts. Thus, a qualified severance has no effect on a taxable termination as defined in section 2612(a) or a taxable distribution as defined in section 2612(b) that occurred prior to the effective date of the qualified severance.

(d) Irrevocable trusts. See §26.2601-1(b)(4) for rules regarding severances and other actions with respect to trusts that were irrevocable on September 25, 1985.

(e) Examples. The rules of this section are illustrated by the following examples:

Example 1. Formula severance. T's will establishes a testamentary marital trust (Trust) that qualifies as qualified terminable interest property (QTIP) under section 2056(b)(7). Trust provides that all trust income is to be paid to T's spouse for life. On the spouse's death, the trust corpus is to be held in further trust for the benefit of T's then-living descendants. On T's date of death in January of 2004, T's unused GST tax exemption is $1,200,000, $200,000 of which T's executor will allocate to bequests to T's

grandchildren. Prior to the due date for filing the Form 706, "United States Estate (and Generation-Skipping Transfer) Tax Return," for T's estate, and thus, prior to the allocation of any GST tax exemption with respect to Trust, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 is to be funded with that fraction of the Trust assets, the numerator of which is $1,000,000, and the denominator of which is the value of the Trust assets as finally determined for federal estate tax purposes. Trust 2 is to be funded with the balance of the Trust assets. On the Form 706 filed for the estate, T's executor makes a QTIP election under section 2056(b)(7) with respect to Trust 1 and Trust 2 and a "reverse" QTIP election under section 2652(a)(3) with respect to Trust 1. Further, T's executor allocates T's available GST tax exemption to Trust 1. If the requirements of section 2642(a)(3) are otherwise satisfied, the severance constitutes a qualified severance. Accordingly, Trust 1 and Trust 2 are treated as separate trusts, and the GST tax elections and GST tax exemption allocation are recognized and effective for generation-skipping transfer tax purposes.

Example 2. Severance of single trust with one income beneficiary. T's will establishes a testamentary trust providing that income is to be paid to T's sister, S, for her life. On S's death, one-half of the corpus is to be paid to T's child, C, or to C's estate if C fails to survive S and one-half of the corpus is to be paid to T's grandchild, GC, or to GC's estate if GC fails to survive S. Prior to the due date for filing the Form 706, T's executor, pursuant to applicable state law, divides the testamentary trust into two separate trusts, Trust 1 and Trust 2, with each trust receiving 50 percent of the current value of the assets of the original trust. Trust 1 provides that trust income is to be paid to S for life with remainder to C or C's estate, and Trust 2 provides that trust income is to be paid to S for life with remainder to GC or GC's estate. Because Trust 1 and Trust 2 provide for the same succession of interests in the aggregate as provided in the original trust, the severance will constitute a qualified severance if the requirements of section 2642(a)(3) are otherwise satisfied. On the Form 706, T's executor may allocate T's available GST tax exemption to Trust 2.

Example 3. Severance of discretionary trust. T's will establishes a testamentary trust (Trust) providing that income is to be paid from time to time in such amounts as the trustee deems advisable to T's children, A and B, and to their respective descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of the last to die of A and B, the trust is to terminate and the corpus is to be distributed in two equal shares, one share to the descendants of each child, per stirpes. Prior to the due date for filing the Form 706, T's executor, pursuant to applicable state law, divides Trust into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that income is to be paid in such amounts as the trustee deems advisable to A and A's descendants. In addition, the trustee may distribute corpus to any trust beneficiary in such amounts as the trustee deems advisable. On the death of A, Trust 1 is to terminate and the corpus is to be distributed to the descendants of A, per stirpes, but if A dies with no living descendants, the principal will be added to Trust 2. Trust 2 contains identical provisions, except that B and B's descendants are the trust beneficiaries and, if B dies with no living descendants, the principal will be

added to Trust 1. Because Trust 1 and Trust 2 provide for the same beneficiaries and the same succession of interests in the aggregate as provided in Trust, and because the severance does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest in Trust, the severance constitutes a qualified severance if the requirements of section 2642(a)(3) are otherwise satisfied.

Example 4. Severance of single trust with two income beneficiaries. T's will establishes a testamentary trust (Trust) providing that Trust income is to be paid to T's children, A and B, for their joint lives. Upon the death of the first to die of A and B, the income will be paid to the survivor. At the death of the survivor of A and B, the corpus is to be distributed equally to T's grandchildren, W and X (with any then-deceased grandchild's share being paid to that grandchild's estate). W is A's child and X is B's child. Prior to the due date for filing Form 706, T's executor divides the testamentary trust equally into two separate trusts, Trust 1 and Trust 2. Trust 1 provides that trust income is to be paid to A for life and, on A's death, the remainder is to pass to W. Trust 2 provides that trust income is to be paid to B for life and the remainder on B's death to X. Because Trust 1 and Trust 2 do not provide A and B with contingent survivor income interests as provided under the terms of the original trust, Trust 1 and Trust 2 do not provide for the same succession of interests in the aggregate as provided in Trust. Therefore, the division is not a qualified severance, and Trust 1 and Trust 2 are treated as one trust. If, however, in this example, Trust 1 instead provides that trust income is to be paid to A for life and then to B (if B survives A), with remainder to W, and if Trust 2 instead provides that trust income is to be paid to B for life and then to A (if A survives B), with remainder to X, then Trust 1 and Trust 2 would provide for the same succession of interests in the aggregate as provided in Trust, and the severance would constitute a qualified severance.

Example 5. Severance of a trust with a 50% inclusion ratio. On September 1, 2004, T transfers $100,000 to a trust for the benefit of T's grandchild, GC. On a timely filed Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return," reporting the transfer, T allocates all of T's remaining GST tax exemption ($50,000) to the trust. As a result of the allocation, the applicable fraction with respect to the trust is .50 [$50,000 (the amount of GST tax exemption allocated to the trust) divided by $100,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .50[1 – .50]. In 2006, pursuant to authority granted under applicable state law, the trustee severs the trust into two trusts, Trust 1 and Trust 2, each of which receives a 50 percent fractional share of the total value of all trust assets at that time. Because the applicable fraction with respect to the original trust is .50 and the trust was severed into two equal trusts, the trustee may designate which trust has an inclusion ratio of one, and which trust has an inclusion ratio of zero. Accordingly, in the Notice of Qualified Severance reporting the severance, the trustee designates Trust 1 as having an inclusion ratio of zero, and Trust 2 as having an inclusion ratio of one.

Example 6. Funding of severed trusts on a non pro rata basis. T's will establishes a testamentary trust (Trust) for the benefit of T's descendants, to be funded

with T's stock in Corporation A and Corporation B. T dies on May 1, 2004, at which time the Corporation A stock included in T's gross estate has a fair market value of $100,000 and the stock of Corporation B included in T's gross estate has a fair market value of $200,000. On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($270,000) to Trust. As a result of the allocation, the applicable fraction with respect to Trust is .90 [$270,000 (the amount of GST tax exemption allocated to the trust) divided by $300,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to Trust is .10 [1 - .90]. On August 1, 2008, when the value of the Trust assets totals $500,000, consisting of Corporation A stock worth $450,000 and Corporation B stock worth $50,000, the trustee severs Trust into two identical trusts, Trust 1 and Trust 2. The terms of the instrument severing Trust provides that Trust 1 is to be funded on a non pro rata basis with assets having a fair market value on the date of funding equal to 90% of the value of the Trust assets on that date, and Trust 2 is to be funded with assets having a fair market value on the date of funding equal to 10% of the value of the Trust assets on that date. Also on August 1, 2008, the trustee funds Trust 1 with all of the Corporation A stock and funds Trust 2 with all of the Corporation B stock. Accordingly, Trust 1 is funded with assets having a value equal to 90% of the value of Trust as of the date of funding, August 1, 2008, and Trust 2 is funded with assets having a value equal to 10% of the value of Trust as of the date of funding. Therefore, if the requirements of section 2642(a)(3) are otherwise satisfied, the severance constitutes a qualified severance. Trust 1 will have an inclusion ratio of zero and Trust 2 will have an inclusion ratio of one.

Example 7. Severance of a trust along family lines. T dies on October 1, 2004. T's will establishes a testamentary trust (Trust) to be funded with $1,000,000. Trust income is to be paid to T's child, S, for S's life. On S's death, Trust is to terminate and the assets are to be divided equally among T's three grandchildren, GC1, GC2, and GC3 (or their respective descendants, per stirpes). On a timely filed Form 706, T's executor allocates all of T's remaining GST tax exemption ($300,000) to Trust. As a result of the allocation, the applicable fraction with respect to the trust is .30 [$300,000 (the amount of GST tax exemption allocated to the trust) divided by $1,000,000 (the value of the property transferred to the trust)]. The inclusion ratio with respect to the trust is .70 [1 - .30]. On June 1, 2007, the trustee determines that it is in the best interest of the beneficiaries to sever Trust to provide a separate trust for each of T's three grandchildren and their respective families. The trustee severs Trust into two identical trusts, Trust 1 and Trust 2, each trust providing that trust income is to be paid to S, for life, and on S's death, the trust is to terminate and the assets are to be divided equally among GC1, GC2, and GC3 (or their respective descendants, per stirpes). The terms of the instrument severing Trust provide that Trust 1 is to receive 30% of the Trust assets and Trust 2 is to receive 70% of the Trust assets. Further, each trust is to be funded with a pro rata portion of each asset held in Trust. The trustee then severs Trust 1 into three equal trusts, Trust GC1, Trust GC2, and Trust GC3. Each trust is named for a grandchild of T and provides that trust income is to be paid to S for life, and on S's death, the trust is to terminate and the trust proceeds distributed to the respective grandchild for whom the trust is named. If that grandchild has predeceased the termination date, the trust proceeds are to be distributed to that grandchild's then-living

descendants, per stirpes, or, if none, to the other grandchildren (or their respective then-living descendants, per stirpes). Each trust is to be funded with a pro rata portion of each Trust 1 asset. The trustee also severs Trust 2 in a similar manner, into Trust GC1(2), Trust GC2(2), and Trust GC3(2). If the requirements of section 2642(a)(3) are otherwise satisfied, the severance of Trust into Trust 1 and Trust 2, the severance of Trust 1 into Trust GC1, Trust GC2, Trust GC3, and the severance of Trust 2 into Trust GC1(2), Trust GC2(2) and Trust GC3(2), constitute qualified severances. Trust GC1, Trust GC2, Trust GC3 will each have an inclusion ratio of zero and Trust GC1(2), Trust GC2(2) , and Trust GC3(2) will each have an inclusion ratio of one.

(f) Effective date. (1) This section applies to severances occurring on or after the date that this document is published in the **Federal Register** as final regulations.

(2) Transition rule. In the case of severances occurring after December 31, 2000, and before the date that this document is published in the **Federal Register** as a final regulation, taxpayers may rely on any reasonable interpretation of section 2642(a)(3) as long as reasonable notice concerning the severance and identification of the trusts involved has been given to the IRS. For this purpose, these proposed regulations are treated as a reasonable interpretation of the statute. For purposes of the notification requirement contained in §26.2642-6(b)(6), notification will be deemed timely if mailed by April 15th of the year immediately following the year during which the severance occurred or the last day of the period covered by an extension of time, if an extension of time is granted. For severances occurring between December 31, 2000, and January 1, 2004, notification will be deemed timely if mailed by November 22, 2004.

Par. 6. Section 26.2654-1 is amended as follows:

1. The paragraph heading for (b) and the introductory text of paragraph (b)(1) are revised.

2. Paragraph (c) is added.

The revision and addition reads as follows:

§26.2654-1 Certain trusts treated as separate trusts.

* * * * *

(b) Division of a trust included in the gross estate occurring on or before December 31, 2000--(1) In general. If a trust that is included in the transferor's gross estate (or created under the transferor's will) is severed on or before December 31, 2000, into two or more trusts, the severance is recognized for purposes of chapter 13 if--

* * * * *

(c) Qualified severance occurring after December 31, 2000. For rules applicable to the severance of a trust for GST tax purposes occurring after December 31, 2000, see §26.2642-6.

Deborah M. Nolan
Acting Deputy Commissioner for Services and Enforcement.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 24, 2004
JS-1872

Treasury and IRS Issue Guidance on Accrual of Remic Income

The IRS and Treasury Department today announced proposed regulations concerning accrual of interest income by the holder of a regular interest in a Real Estate Mortgage Investment Conduit (REMIC).

The proposed regulations respond to industry concerns resulting from investor confusion about the appropriateness of the current practice, which generally reports too little income to the first holder of a REMIC regular interest. REMIC sponsors and servicers have expressed concern that current practice creates economic distortions.

"The method in the proposed regulations better reflects the underlying economics of the transaction than does the current practice it would replace ," said Greg Jenner, Acting Assistant Treasury Secretary for Tax Policy. "It represents sound tax policy and also addresses industry concerns about distortion."

The proposed regulations were filed today with the Federal Register and will be published August 25, 2004.

REPORTS

- The text of the proposed regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-108637-03]

RIN 1545-BB94

Accrual for Certain REMIC Regular Interests

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the accrual of original issue discount (OID) on certain real estate mortgage investment conduit (REMIC) regular interests. The proposed regulations are necessary to provide guidance to REMICs, REMIC regular interest holders and information reporters regarding the accrual of OID. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by November 23, 2004. Outlines of topics to be discussed at the public hearing scheduled for November 17, 2004, must be received by October 27, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-108637-03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-108637-03), Courier's Desk, Internal Revenue

Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS -- REG-108637-03). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, contact Rebecca Asta at (202) 622-3930. To be placed on the building access list for the hearing, contact Sonya Cruse at (202) 622-7180.

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

1. General Background

A debt instrument may provide for qualified stated interest (QSI) (that is, certain periodic payments of stated interest), OID, or both. Sections 163(e) and 1271 through 1275 provide rules for the treatment of OID on debt instruments. In general, the holder of a debt instrument includes OID in income as it accrues, even if the holder generally uses a cash method of accounting. A holder of a REMIC regular interest includes QSI in income under an accrual method of accounting because section 860B(b) requires that amounts includible in gross income with respect to a REMIC regular interest be determined under an accrual method.

For many debt instruments, only one or two days separate the date on which the holder becomes entitled to a payment (the record date) from the date on which the holder

receives payment (the payment date). For REMIC regular interests, however, the record date may precede the payment date by 15 to 30 days.

2. Current REMIC Accrual Practice

Under the governing contract provisions, REMIC regular interests generally accrue interest from the issue date to the final record date, and holders become entitled to receive interest payments based on month-end record dates. The IRS and the Treasury Department understand, however, that, in general, REMIC servicers have interpreted the OID rules to require or permit holders' OID to accrue for tax purposes over the period from payment date to payment date and have treated QSI as accruing over the same periods. To compensate for accruing QSI and OID beyond the final record date to the final payment date, the servicers have treated QSI and OID on REMIC regular interests as not accruing from the date of issue for a period equal to the number of days between the record date and payment date. In effect, for tax purposes, the tax accrual of QSI and OID lags the legal accrual of interest by the delayed payment period.

For tax purposes, as of the date a REMIC regular interest is purchased in the secondary market, the purchaser begins to accrue QSI and OID, and the seller ceases to accrue QSI and OID. A purchaser that holds the instrument until the final payment date or redemption accrues QSI and OID past the final record date as long as it holds the instrument. A purchaser that begins to accrue QSI and OID on the purchase date gives up the benefit of the lag in the beginning of the accrual period. As a result, the delayed accrual system causes the last secondary market purchaser of a REMIC regular interest to accrue

for tax purposes an additional number of days of QSI and OID equal to the number of days between the record and payment dates, and too much QSI and OID is allocated to the last secondary purchaser of the REMIC regular interest. Moreover, because of principal payments, the holder will earn interest on a declining principal balance, while the lagging tax accruals will be based on a higher principal amount between record dates and payment dates in many instances. Consequently, a secondary market purchaser that is not the last secondary market purchaser will experience tax accruals in excess of legal entitlements if the regular interest has significant stated principal and bears interest at a stated rate.

3. Overview of the Proposed Regulations

The proposed rules address the misallocation of QSI and OID by creating a special rule for accruing OID on REMIC regular interests that provide for a delay between record and payment dates. Under the proposed regulations, the period over which OID accrues generally coincides with the period over which the holder=s right to interest payments accrues under the governing contract provisions.

Generally, under the proposed regulations, if the terms of a REMIC regular interest provide for a delay between the record and payment dates, the initial accrual period begins on the date of issuance of the regular interest, and the final accrual period ends on the final record date of that REMIC regular interest. By shifting the entire tax accrual schedule, this special rule allocates all QSI and OID to the period between the issue date and the final record date of the instrument and none to the period between the final record date and final payment date. For purposes of calculating OID in the final accrual period with the

methodology described in section 1272(a)(6), but for no other purpose, payments on the REMIC regular interest after the end of that accrual period that are included in the stated redemption price at maturity of the instrument (such as the payment on the final payment date) are treated as being made during the final accrual period.

The IRS and Treasury Department recognize that, although the proposed regulations result in a more accurate allocation of QSI and OID among REMIC regular interest holders, some economic accuracy may be sacrificed by ending the accrual of OID before final payments are made on the regular interests. Therefore, the proposed regulations are limited to REMIC regular interests with delayed payment periods of fewer than 32 days. The regulation regarding REMIC regular interests with delayed payment periods of more than 31 days is reserved. The IRS and Treasury Department request comments on whether additional guidance is needed for these REMIC regular interests.

4. Accrual of Qualified Stated Interest

Section 1.1272-1(a) requires a holder to include QSI in income under the holder=s regular method of accounting. Section 1.446-2(b) requires a holder, as well as the issuer, to accrue QSI ratably over the accrual period to which it is attributable. In addition, section 860B(b) requires a holder of a regular interest to accrue amounts into gross income regardless of the holder=s overall method of accounting. The amounts that must be so accrued include QSI. The Treasury Department and the IRS understand that many REMIC servicers have accrued QSI over the same period as OID. It is intended that, with respect to the accrual periods referenced in ' 1.446-2(b), the initial accrual period for QSI will begin

on the date of issuance and the final accrual period for QSI will end on the final record date. As a result, the QSI accrues over the same period as the OID.

Proposed Effective Date

These regulations are proposed to apply to any REMIC regular interest issued after the date the final regulations are published in the **Federal Register**. The proposed regulations provide automatic consent for the holder of a REMIC regular interest to change its method of accounting for OID under the final regulations. The change is proposed to be made on a cut-off basis and, thus, does not affect REMIC regular interests issued before the date the final regulations are published in the **Federal Register**.

The Treasury Department and the IRS are concerned regarding the extent to which holders of REMIC regular interests will be aware that changes in accounting methods for QSI may be necessary to comply with the special rule in the proposed regulations. If a holder of REMIC regular interests relies on data provided on behalf of the REMIC rather than performing its own computations, the holder may be unaware that these rules will have required newly issued REMICs to alter the accrual periods over which interest reported to holders is computed. The Treasury Department and the IRS request comments on the way in which a change in accounting method for QSI should be effected.

The Treasury Department and the IRS request comments concerning the extent to which any other debt instruments provide for a significant delay between record and payment dates and, if some do, whether rules like those in the proposed regulations should

be extended to them. Any comments received will be considered in connection with the publication of final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory flexibility assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the 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 written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and IRS specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 17, 2004, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW.,

Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. 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 AFOR 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 November 23, 2004, and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 27, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of 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 proposed regulations is Rebecca Asta of the Office of Associate Chief Counsel (Financial Institutions and Products). 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 continues to read in part as follows:

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

Par. 2. Section 1.1271-0 is amended by adding entries for ' 1.1275-2(l) and (m) to read as follows:

' 1.1271-0 Original issue discount; effective date; table of contents.

* * * * *

' 1.1275-2 Special rules relating to debt instruments.

* * * * *

(l) [Reserved]
(m) Special rule for certain REMIC regular interests.
(1) Scope.
(2) General rules.
(3) Special rule for calculation of OID in final accrual period.
(4) Definition of record date.
(5) Accrual of qualified stated interest.
(6) Example.
(7) Treatment of REMIC regular interests if the record dates and the payment dates are separated by more than thirty-one days.
(8) Effective date.

* * * * *

Par. 3. Section 1.1275-2 is amended by adding new paragraphs (l) and (m) to read as follows:

1.1275-2 Special rules relating to debt instruments.

* * * * *

(l) [Reserved].

(m) Special rules for certain REMIC regular interests--(1) Scope. If the terms of a REMIC regular interest (as defined in section 860G(a)(1)) provide for a delay between its

record dates and the associated payment dates, the initial accrual period and final accrual period for that regular interest are determined under this paragraph (m). Except as provided in paragraph (m)(7) of this section, this paragraph (m) does not apply to a REMIC regular interest if the record dates and the payment dates are separated by more than thirty-one days.

(2) General rules--(i) Initial accrual period. The initial accrual period for a REMIC regular interest subject to this paragraph (m) begins on issuance of the REMIC regular interest.

(ii) Final accrual period. The final accrual period for a REMIC regular interest subject to this paragraph (m) ends on the final record date of the REMIC regular interest.

(3) Special rule for calculation of OID in final accrual period. In applying section 1272(a)(6)(A) to calculate OID in the final accrual period for a REMIC regular interest subject to this paragraph (m), payments after the end of the final accrual period of amounts included in the stated redemption price at maturity are treated as payments during the final accrual period.

(4) Definition of record date. For purposes of this paragraph (m), a record date of a REMIC regular interest is a date, provided by the terms of the REMIC regular interest, on which the holder becomes entitled to a payment (of interest or principal) that is to be made on a subsequent payment date.

(5) Accrual of qualified stated interest. See ' 1.446-2 for the accrual of qualified stated interest.

(6) Example. The following example illustrates the application of this paragraph (m).

Example. REMIC X issues regular interests on January 1, 2009. The terms of the regular interests provide for payments of interest and principal to the persons who hold the regular interests on the last day of the calendar month (the record date). Each such payment is to be made on the fifteenth day of the succeeding calendar month (the payment date). The last payment with respect to the regular interests issued by REMIC X is to be made on January 15, 2014, to persons who hold the regular interests on December 31, 2013. Under this paragraph (m), the initial accrual period begins on the date of issuance, January 1, 2009, and the last accrual period ends on the last record date, December 31, 2013.

(7) Treatment of REMIC regular interests if the record dates and the payment dates are separated by more than thirty-one days. [Reserved]

(8) Effective date--(i) In general. This paragraph (m) applies to REMIC regular interests issued after the date the final regulations are published in the **Federal Register**.

(ii) Automatic consent to change method of accounting. Taxpayers are hereby granted the Commissioner=s consent under section 446(e) to change their method of accounting for REMIC regular interests to which this paragraph (m) applies if--

(A) The change involves changing accrual periods to accrual periods allowed by this paragraph (m);

(B) The change is made for the first taxable year of the taxpayer during which the taxpayer holds a REMIC regular interest to which the rules of this paragraph (m) apply; and

(C) The change in method of accounting is effected on a cut-off basis.

/s/ Deborah M. Nolan

Acting Deputy Commissioner for Services and Enforcement

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FROM THE OFFICE OF PUBLIC AFFAIRS

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August 24, 2004
JS-1873

Treasury and IRS Request Comments on Remic Issues

The IRS and Treasury Department today requested comments on the tax treatment of interest-only regular interests (I/Os) in a Real Estate Mortgage Investment Conduit (REMIC).

REMICs I/Os entitle the holders to a specified portion of the interest paid on the pool of mortgages held by the REMIC, but not to any principal payments. The total interest payments may be less than the amount for which the I/O was originally issued. As a result, the tax results sometimes differ substantially from the economics of the transactions.

The request for comments discusses two possible solutions. "The solutions outlined in the notice are intended to prompt a meaningful dialogue, including suggestions regarding alternatives," commented Greg Jenner, Acting Assistant Treasury Secretary for Tax Policy. "They demonstrate our willingness to consider innovative approaches. We hope to attract the sort of creative comments that are necessary to address the difficult issues inherent in the taxation of REMIC I/Os."

The request for comments was filed this morning at the Federal Register and will be published August 25, 2004.

REPORTS

- The text of the ANPRM

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106679-04]

RIN 1545-BD18

Interest-only REMIC Regular Interests

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: This document describes and explains rules that the IRS and Treasury are considering and may propose in a notice of proposed rulemaking regarding the proper timing of income or deduction attributable to an interest-only regular interest in a Real Estate Mortgage Investment Conduit (REMIC). This document also invites comments from the public regarding these rules and other alternative rules. All materials submitted will be available for public inspection and copying.

DATES: Written or electronic comments must be received by November 23, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-106679-04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-106679-04), Courier's Desk, Internal

Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-106679-04).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments, Treena Garrett (202) 622-7180; concerning the proposals, Dale S. Collinson, (202) 622-3900 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

BACKGROUND

The Tax Reform Act of 1986 (100 Stat. 2085) (1986-3 C.B. Vol. 1), created a new tax entity, the Real Estate Mortgage Investment Conduit (REMIC), that was designed to be the exclusive vehicle for the issuance of multi-class mortgage-backed securities. A REMIC may issue one or more classes of regular interests and must issue a single class of residual interest. Section 860B(a) of the Internal Revenue Code (Code) requires that a regular interest be treated as a debt instrument whether or not the interest would qualify as a debt instrument under general tax principles. The holders of the residual interest are required to take into account their proportionate share of the REMIC's taxable income or net loss.

Prior to 1988, the holder of a REMIC regular interest was required to be entitled to a specified principal amount plus

interest at a fixed or variable rate. The Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342) (1988 C.B. 1), permits the holder of a REMIC regular interest to receive interest that consists of a specified portion of the interest payments on qualified mortgages if the portion does not vary during the period the regular interest is outstanding. Section 860G(a)(1)(B)(ii). The expanded definition of REMIC regular interest has allowed for the issuance of interest-only REMIC regular interests (REMIC IOs).

A REMIC IO generally provides for a nominal (or zero) specified principal amount and stated interest consisting of a specified portion of the interest payments on mortgages held by the REMIC.[1] Section 860B(a) provides that a REMIC regular interest is taxed as a debt instrument. Nevertheless, a REMIC IO differs from a traditional debt instrument in that the aggregate of the amounts received by the holder of a REMIC IO may be less than the amount for which the instrument was issued. This may occur if the underlying mortgages are prepaid at an unexpectedly rapid rate. In that case, the amounts of interest paid on these mortgages will be less than expected, and the

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[1]The terms of a REMIC may provide that the specified principal amount of a REMIC IO is zero. Although section 860G(a)(1)(A) requires a regular interest "unconditionally [to] entitle[] the holder to receive a specified principal amount (or other similar amount)," §1.860G-1(a)(2)(iv) states, "If an interest in a REMIC consists of a specified portion of the interest payments on the REMIC's qualified mortgages, no minimum specified principal amount need be assigned to that interest."

amounts payable to the holder of the REMIC IO will be correspondingly reduced. As a result, REMIC IOs present novel and difficult questions in the application of tax rules that were designed primarily to account for instruments that qualify as debt under traditional tax principles.

Section 1275(d) authorizes regulations to modify the tax treatment prescribed by sections 163(e) and 1271 through 1275 (relating to original issue discount (OID)) if the statutory tax treatment does not carry out the purposes of those sections. The IRS and Treasury are considering whether to issue regulations, including regulations under the authority of section 1275(d), with respect to the tax treatment of REMIC IOs for issuers and initial- and secondary-market purchasers. This advance notice of proposed rulemaking sets out additional background information, including summary descriptions of possible approaches to the problems described below, and requests public comment.

CURRENT TAX TREATMENT OF REMIC IOs

As noted, the terms of a REMIC IO generally provide both for stated interest consisting of a specified portion of the interest payments on mortgages held by the REMIC and also may provide for a nominal amount of specified principal. The tax rules currently applicable to a REMIC IO depend on whether the stated interest is treated as consisting entirely of

interest or as being, in part, a return of the proceeds for which the instrument was issued.

Some taxpayers believe that, if the stated interest is respected as interest, it generally is qualified stated interest (QSI) and so is not part of the stated redemption price at maturity (SRPM). As a result, because the specified principal due on the REMIC IO is, at most, nominal, a holder generally will have paid more than the amount payable when the REMIC IO matures, and thus there will be bond premium. On the other hand, if the interest payments are recast as, in part, a return of the proceeds for which the REMIC IO was issued, the portions so recast are included in the SRPM, and the instrument is issued with OID.

Glick v. United States, 96 F. Supp. 2d 850 (S.D. Ind. 2000), weighed these competing analyses of a REMIC IO. The instrument at issue in the case had been issued for a little over $12 million. The terms of the instrument provided both for specified principal of $362,000, which was based on principal payments on the underlying mortgages, and for much larger expected amounts of stated interest, which were linked to, and contingent upon, interest payments on the underlying mortgages.

Given the terms of the mortgages and the rate at which the mortgagors were, in the aggregate, expected to prepay their mortgages, the prospectus estimated total future cash flows

under the REMIC IO of over $14 million. Basing its computation on the specified principal amount, the prospectus identified the resulting estimated interest rate on the REMIC IO as being 1006.7 percent. On the other hand, the prospectus further disclosed that, if a yield computation were to be based on the taxpayer's purchase price of over $12 million, the anticipated yield to maturity was just under 8 percent.

Because of falling interest rates, the mortgages underlying the instrument were prepaid at an extremely fast rate, and the taxpayer recovered less than two thirds of the original investment.

The Government argued that the instrument was issued at a discount and that the taxpayer's loss on the instrument was capital and would be recognized only in the year the instrument was retired. The taxpayer, on the other hand, claimed that the instrument was acquired at a premium and that ordinary deductions were allowable under section 171 during the entire period that the taxpayer held the instrument. Explaining that it had resolved the question by "[e]xamining the economic reality of the transaction," 96 F. Supp. 2d at 867, the court issued summary judgment for the Government.

Original Issue Discount

REMIC regular interests are among the debt instruments for which the accrual of OID is calculated taking prepayments

into account. This is accomplished by using a method commonly known as the prepayment assumption catch-up (PAC) method, which is provided in section 1272(a)(6). Under this method, it is necessary to estimate first the rate at which any outstanding principal on the underlying mortgages will be prepaid and, then, the yield to maturity of the instrument. These estimates remain constant in all PAC method computations throughout the life of the instrument.

In each accrual period, the daily accruals of OID are equal to the ratable portion of the excess (if any) of the sum of (1) the present value of the remaining payments under the debt instrument as of the close of the period (end-of-period present value) and (2) the payments during the accrual period that are included in the SRPM(accrual-period SRPM receipts), over the adjusted issue price of the debt instrument at the beginning of the period.[2]

The end-of-period present value is calculated using the two estimates referred to above. First, the amount and time of the remaining payments are determined on the basis of both the specified principal actually outstanding at the end of the accrual period (taking into account any prepayments occurring before the close of the accrual period) and the previously

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[2] For each period, interest income or expense with respect to the REMIC regular interest also includes accruals of QSI.

estimated, static assumption about the rate at which any outstanding principal will be prepaid. Second, the present value of these remaining payments is determined by discounting them at the previously estimated original yield to maturity.

A holder of an OID debt instrument includes in gross income the sum of the daily portions of the OID for each day during the taxable year on which it holds the debt instrument. An issuer's interest deduction for OID accruals is computed in a similar fashion.

In the case of a traditional debt instrument that is issued with OID or a REMIC regular interest that is issued for less than its specified principal amount, prepayments increase the instrument's yield to maturity. Failure to anticipate prepayments would result in uneconomic deferred accrual of OID inclusions, and the holder would recognize capital gains when the instrument is finally sold or retired. To prevent such uneconomic deferral of OID inclusions, the PAC method, in each period, recognizes more OID than would be recognized if no anticipated prepayments were taken into account. However, the PAC method may result in uneconomic acceleration of OID accruals in certain circumstances.

When section 1272(a)(6) became law, an instrument subject to it generally provided for payments of a fixed amount of specified principal, plus payments of QSI, which were based

on the amount of principal still outstanding. If the issue price of the instrument was less than the specified principal, that difference resulted in a fixed amount of OID, which had to be accrued over the life of the instrument.

For such an instrument, if actual prepayments occur at a slower rate than the original estimate, OID will be accrued more rapidly under the PAC method than the actual prepayment rate would justify. If prepayments are particularly slow, the OID remaining to be received at the end of a period may be greater than the excess of the original OID on the instrument over the amount of the OID that had been accrued in prior periods. As a result, the amount of OID for the current accrual period under the formula in the PAC method may be a negative number (Negative OID).[3] This occurs if the adjusted issue price at the beginning of an accrual period (which reflects prior OID accruals) exceeds the sum of (1) the end-of-period present value and (2) the accrual-period SRPM receipts.

Because the amount of OID to be received over the life of the instrument is fixed, and thus the OID that had been previously accrued will be received eventually, the premature accruals may be addressed by a period of nonaccrual of OID. An alternative approach would be to reverse the premature accruals

[3] In 1986 Congress expressed its intent that Negative OID would not be currently recognized. For that reason, the term is used here to refer to a negative result for the computation required by the formula in the PAC method, not to an amount that is necessarily recognized for tax purposes.

by recognizing Negative OID in the current period and then to accrue the OID again later.

In enacting the PAC formula, Congress expressed its intent that the rules implementing the PAC method would use a period of nonaccrual to correct possible premature accruals and would not accrue and recognize Negative OID.

> The conferees intend that in no circumstances, would the method of accruing OID prescribed by the conference agreement allow for negative amounts of OID to be attributed to any accrual period. If the use of the present value computations prescribed by the conference agreement produce[s] such a result for an accrual period, the conferees intend that the amount of OID attributable to such accrual period would be treated as zero, and the computation of OID for the following accrual period would be made as if such following accrual period and the preceding accrual period were a single accrual period.

2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-239, 1986-3 (Vol. 4) C.B. 239. The IRS and Treasury understand that taxpayers generally comply with this intent not only for ordinary REMIC regular interests but also for REMIC IOs.

The quoted expression of Congressional intent occurred before the 1988 amendment permitting REMIC IOs. In the case of a REMIC regular interest that resembles a traditional debt instrument (such as the regular interests that existed before the 1988 amendment), a Negative OID computation is evidence that unexpectedly <u>slow</u> prepayments may have caused OID to accrue more rapidly than, in

hindsight, it should have. In such a situation, disallowing Negative OID causes a timing issue. To the extent that OID has been overaccrued, the accrual period is extended until the computation for the extended accrual period produces a positive result. This future positive result of the computation has to occur eventually as principal on the debt instrument is repaid.

By contrast, in the case of a REMIC IO, a Negative OID computation may occur because unexpectedly rapid prepayments reduce the amount of OID that will ever be received or paid under the terms of the instrument. Rather than the right amount of OID being accrued too fast, the wrong amount has been accrued. In the case of a REMIC IO, therefore, the prohibition against Negative OID may result in denying the holder current recognition of an overall actual loss that will not be reversed in future periods and may only be realized upon the sale or maturity of the REMIC IO.

There is also a corresponding distortion to the net income or net loss of the REMIC (and thus to the income or net loss of the holder of the residual interest). Even if one or more holders of the REMIC IOs sell their interests and recognize losses that correct their own overaccrual of OID income, nothing corrects the REMIC's overaccrual of OID deductions until the

instrument is finally retired. This asymmetry may result in an understatement of the overall tax base attributable to income from mortgages held in REMICs (the total amount taxable to holders of REMIC regular interests and REMIC residual interests).

Market Discount

Section 1276(b)(3) provides that the accrual of market discount on a debt instrument the principal of which may be paid in installments shall be determined under regulations. Regulations have not yet been issued.

The legislative history of the Tax Reform Act of 1986, however, states that, until regulations are issued, if a debt instrument is issued with OID and the principal of the instrument may be paid in two or more installments, then holders of the instrument may elect to accrue market discount for the instrument either on a constant yield basis or in proportion to the OID accruals on the instrument. Under the latter method, the amount of market discount that accrues during an accrual period is determined by multiplying the total remaining amount of market discount on the instrument as of the beginning of the period by a fraction the numerator of which is the amount of OID for the period and the denominator of which is the total

remaining OID at the beginning of the period.[4] See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-842 (1986), 1986-3 (Vol. 4) C.B. 842. The IRS and Treasury understand that, under current practice, during any period for which the PAC method produces Negative OID, the numerator of the fraction is treated as zero, and no market discount is accrued. In some cases, this practice may uneconomically defer recognition of market discount.

If the rules in section 1272(a)(6) apply to a debt instrument (without regard to whether the instrument is issued with OID), this legislative history indicates that accruals of market discount on the instrument are to be determined using the same prepayment assumption as that used under section 1272(a)(6) (whether or not the taxpayer elects under section 1276(b)(2) to accrue market discount on a constant-yield basis). See id.

The IRS and Treasury are aware of several possible methods, discussed below, for addressing the foregoing problems.

INSTRUMENTS TO WHICH NEW RULES MIGHT APPLY

Because of the range of instruments to which section 1272(a)(6) applies and the breadth of the new accounting methods about which comment is being requested, any new method

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[4] If an instrument that provides for two or more principal payments is issued without OID, Congress intended for market discount to be accrued according to the same rule, but with stated interest playing the role of OID. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-842 (1986), 1986-3 (Vol. 4) C.B. 842.

might not necessarily be limited to REMIC IOs. For example, a new method might apply to interest-only strips from fixed investment mortgage trusts. In addition, a new method might apply to all instruments that provide for disproportionately high interest payments (as defined in §1.860G-1(b)(5)). Under this approach, the new rules would apply to REMIC regular interests whose issue price exceeds 125% of the specified principal amount and to similar non-REMIC interests.

PROPOSALS BASED ON EXISTING RULES FOR DEBT

PAC Method Without Prohibition On Recognizing Negative OID

Although the PAC method may sometimes fail to clearly reflect the income of the holder or the issuer of a REMIC IO, the method is not without merit. The method is specifically designed to deal with debt instruments that are subject to prepayments, like traditional REMIC regular interests. Under the PAC method, if loans are actually prepaid faster than expected, the projected future cash flows are adjusted immediately to more accurately reflect income. To a large extent, the problems arising from the application of the PAC method to REMIC IOs arise from the prohibition against taking Negative OID into account.

Because REMIC IOs did not exist when the 1986 legislative history discussing Negative OID was drafted, that discussion related to a Negative OID computation that would

indicate that the affected taxpayers had accrued some OID too soon, rather than that they had accrued OID that would never be paid or received. Congress might have articulated a different intent concerning Negative OID if it had addressed the issue once REMIC IOs were permitted.

Accordingly, the IRS and Treasury are considering whether to propose a regulation that would follow the section 1272(a)(6) formula in the current PAC method, except that the regulation would specifically allow holders of regular interests to accrue Negative OID deductions and would require the REMIC (and thus the holder of the REMIC residual interest) to accrue and recognize income from Negative OID.

The considerations supporting recognition of Negative OID by initial purchasers may not apply with equal force to secondary-market purchasers. Secondary market prices are likely to reflect both prepayment history and revised expectations regarding future prepayments, with the result that the Negative OID deduction that might be appropriate for an initial purchaser may exceed any actual economic loss sustained by a particular secondary-market purchaser. The secondary-market purchaser's depressed purchase price, however, is likely to result in a substantial amount of market discount. See section 1278(a)(2). The rules for accruing Negative OID and market discount will

have to be coordinated to produce a net result that is economically sensible.

Accordingly, it may be appropriate either to develop explicit rules to effect this coordination or to limit recognition of Negative OID in the case of secondary-market purchasers. For example, recognition of accrued Negative OID might be limited to the aggregate of amounts that the secondary-market holder previously included in income as accrued OID or accrued market discount. However, in the case of a secondary-market holder who has suffered a real economic loss on a REMIC IO, such a limitation could uneconomically defer recognition of that loss.

Moreover, if a limitation on the allowance of Negative OID is applied to secondary-market purchasers, perhaps a similar limitation for initial purchasers will be needed to avoid disparate treatment of similarly situated holders (for example, initial purchasers and secondary-market purchasers that purchase shortly after original issuance at a price substantially the same as the issue price). However, such a limitation would also perpetuate many of the problems previously described.

Any rule recognizing Negative OID would have to deal with a variety of collateral consequences, such as adjustments to the instrument's adjusted issue price and the holder's basis in the instrument to reflect any deduction for Negative OID.

Comments are requested concerning both the range of collateral consequences of recognizing Negative OID and the ways in which these consequences should be dealt with.

Allowing Section 166 Bad Debt Deduction

Another way to more clearly reflect the income of holders of REMIC IOs would be to issue regulations under section 166 (which concerns deductions for bad debts). These rules might both determine when (prior to realization) a holder has sustained an economic loss and also allow a deduction for the loss under section 166.[5] Section 166(a) provides a deduction for any debt that becomes wholly or partially worthless during the taxable year. Indeed, some holders of REMIC IOs have claimed deductions for partial worthlessness under section 166(a)(2) and §1.166-3. The rules for determining worthlessness and partial worthlessness, however, were developed with reference to debts that become worthless or partially worthless because of the issuer's anticipated failure ever to make required payments, not because certain contingencies (such as rapid prepayments) have reduced the amounts required to be paid. Thus the existing regulations under section 166 focus on whether a debt instrument is uncollectible and cannot be fully satisfied

[5]Section 165(g) allows a deduction for losses on worthless "securities," as defined in section 165(g)(2)(C). REMIC regular interests, however, fall outside this definition, because they are not issued by a government, a political subdivision, or a corporation. (Under section 860A(a), a REMIC is not treated as a corporation.)

through foreclosure on collateral. See, for example, §§1.166-2 and 1.166-6. By contrast, the existence of Negative OID for a REMIC IO is evidence that the amounts contractually owed under the terms of the instrument are being reduced, not that the holder cannot collect whatever amounts are so owed.

Comments are invited regarding (1) whether, in the absence of any default by the issuer, the policy underlying the allowance of a deduction for worthlessness and partial worthlessness should be extended to a change in the amount that the issuer is required to pay, and (2) whether any rule allowing a deduction under section 166 can be extended to, or combined with, rules respecting corresponding income inclusions for REMICs and the timing of the inclusions.

ALTERNATIVE PROPOSAL SPECIFIC TO REMIC IOS AND SIMILAR INSTRUMENTS

The foregoing discussion attempts to provide a method for recognizing interest income and deduction from a REMIC IO by altering an existing method applicable to traditional debt instruments. Although it may be possible to alter an existing method, doing so is difficult because existing methods are designed to apply to debt and a REMIC IO is unlike most debt. Furthermore, as previously indicated, altering an existing method often leads to collateral problems that must be addressed. Therefore, an alternative method created especially

for REMIC IOs, and similar instruments, may better reflect the income and deductions for these instruments.

Economically a holder of a REMIC IO (like other investors) has invested cash in an instrument and expects to receive cash flows from that investment. What is distinctive about a REMIC IO is that the amount and duration of the cash flows are unknown at the time of making the investment. Given the economics of the REMIC IO, a method for distinguishing between receipt of income and recovery of the amount originally invested could be based on the projected (but uncertain) cash flows under the instrument and not on the expectation of a fixed return. The following method attempts to achieve that objective.

First, the holder of a REMIC IO would include payments made on the REMIC IO in income as they are received. The holder would then be allowed an offset to any payments included in income for the period. The offset would be equal to an amount that bears the same ratio to the investment as the payments for the period bears to the total expected payments (based on a prepayment speed assumption). The total expected payments would be calculated each period taking into account both an updated prepayment-speed assumption and any payments made on the REMIC IO. For this purpose, the investment is the total investment cost (i.e., the issue price).

Offset Formula: $\text{Offset} = \text{Investment} \times \frac{\text{Payments for period}}{\text{Total expected payments}}$

At the maturity of the IO, and perhaps at earlier times, a look-back regime may be appropriate to correct any under- or over-accrual of interest. See section 167(g)(2).

For an example of this method, see the appendix.

Comments are requested on two aspects of this IO-specific method in particular. First, can a variation of the method be applied to determine appropriate interest deductions for the REMIC? Second, in the typical REMIC IO, cash-flows start high and then decline to zero. For these instruments, the new method may clearly reflect income. One of the method's weaknesses, however, is that, unlike OID accrual generally, the method does not accrue OID prior to the receipt of the cash representing the OID. An issue exists as to what regime should apply if the application of existing regulations to tiered structures produces REMIC IOs the cash flows on which are not expected to begin until well after the issue date.

SECONDARY-MARKET PURCHASERS

Unlike initial purchasers, taxpayers who acquire REMIC regular interests subsequent to issue may have to take into account not merely accruals of OID but a combination of OID and market discount or a combination of OID and acquisition premium. As discussed above, the issues concerning OID accruals and the

possible recognition of Negative OID require separate consideration with respect to secondary-market acquisitions.

The IRS and Treasury are considering alternative rules for the accrual of market discount attributable to REMIC IOs. One possible rule is to require accruals under a formula similar to the PAC method, including the use of a prepayment assumption and discount rate that remain static. However, instead of the projected prepayment speed and the projected yield to maturity being fixed as of the date on which the REMIC issues all of its regular interests, they would be fixed for a subsequently acquired REMIC IO at the time of the acquisition. Essentially a holder of a REMIC IO would apply the same methodology regardless of whether its acquisition was on the issue date (with the holder calculating OID based on estimates that were fixed on that date) or on a subsequent date (with the holder calculating market discount based on estimates that were fixed on the subsequent acquisition date).

If the amount of market discount is based on the revised issue price, as provided in section 1276(a)(2) and (4), the rules will need to integrate accrual of market discount (which will be specific to each holder) and accrual of OID (which will be the same for all holders). If the amount of market discount is based on remaining SRPM at the time of acquisition, accrual of the market discount will be a substitute

for any OID accrual. In either case, a holder with any market discount will need substantial amounts of individualized data from the REMIC servicer. Comments are requested as to the REMIC servicer's ability to provide the necessary individualized data.

It would be possible to revise the rules for accrual of market discount without adopting a rule recognizing Negative OID. As described above, however, if this recognition is permitted generally and is made available to secondary-market purchasers as well as initial purchasers, additional questions will be presented for secondary-market purchasers. These would include whether the amount of market discount should be redetermined and, if so, what the effect of that determination would be on collateral consequences of market discount such as the deferral of interest deductions under section 1277. One possibility would be to condition the recognition of Negative OID for secondary-market purchasers on an election by the holder to be taxable under the OID rules on both OID and market discount or premium. (See the election under §1.1272-3.)

NEGATIVE YIELD INSTRUMENTS

The IRS and Treasury are aware that there are some REMIC IOs for which the prepayment speed that the servicer projected at the pricing date produces a projected negative yield. Arms-length investors do not voluntarily enter transactions with anticipated negative yields. Rather, such an

investor may subjectively anticipate a different prepayment speed, or the investor may be "making a bet" on the occurrence of a prepayment scenario with a rate of return that more than compensates for its low probability of occurring. Mathematically, "discounting" a cash flow at a negative yield produces a present value that is greater than the sum of the future values of the cash flow. Unmodified application of the PAC method would therefore be unreasonable because it would require the holder to include amounts in income that are based on unrealistically high deemed present values of future cash flows. Comments are requested on whether the PAC method should be altered by requiring the use of a discount rate that is no less than an economically reasonable discount rate or whether some other adjustment would be more appropriate.

REQUEST FOR COMMENTS

The IRS and Treasury request comments on the desirability of adopting special rules for taxing REMIC IOs, high-yield REMIC regular interests, and apparent negative-yield instruments, and whether those special rules should also be applied to other similar instruments (including how to identify such similar instruments). Comments and suggestions are also requested regarding possible approaches to what additional special rules may be desirable, including the possible recognition of Negative OID, the formulation of special

guidelines for the application of section 166 to REMIC IOs and similar instruments, and the adoption of a new alternative method applicable to REMIC IOs and similar instruments.

Persons providing comments may want to consider, among other things, the following questions. Should recognition of Negative OID be limited to prior inclusions of OID, to prior inclusions of OID and market discount, or to some other amount? If any limit is imposed, should the limit apply to all holders or only to those who do not acquire their interests at original issue? If recognition of Negative OID by initial purchasers is limited to prior OID inclusions, should recognition of Negative OID be permitted for secondary-market purchasers to the extent of prior market discount inclusions as well as OID inclusions? If recognition of Negative OID is unlimited for initial purchasers, should it be limited for secondary-market purchasers? Should recognition of Negative OID for secondary-market purchasers result in a redetermination of a purchaser's market discount and, if so, should the redetermination affect the application of the interest deferral provisions in section 1277? Alternatively, is the situation addressed adequately by currently recognizing both Negative OID and currently accruing market discount? Should recognition of Negative OID by

secondary-market purchasers be conditioned on an election to treat all discount and premium on the instrument as OID?

Acting Deputy Commissioner for Services and Enforcement.

APPENDIX

Examples

Issue Price $8.97 Expected Yield 8.455%

Expected Cash Flows:

Year 0	(8.97)
Year 1	5.00
Year 2	2.50
Year 3	1.50
Year 4	1.00
Year 5	0.50

If pays as expected:

End AIP	Payments	Beg. AIP	OID
4.73	5.00	8.97	.76
2.63	2.50	4.73	.40
1.35	1.50	2.63	.22
0.46	1.00	1.35	.11
0	0.50	0.46	.04
			1.53

Actual Yield 8.455%

If pays faster than expected:

End AIP	Payments	Beg. AIP	OID
1.89	5.00	8.97	(1.11)
1.05	1.00	2.86	(0.35)
0.54	0.60	1.50	(0.19)
0.18	0.40	0.72	(0.09)
0	0.20	0.23	(0.03)
			(1.77)

Actual Yield -12.397%

Holder's OID Income under Current Rules (w/ Negative OID prohibition):

Year 1	0
Year 2	0
Year 3	0
Year 4	0
Year 5	0

1.77 loss at maturity

Holder's OID income under Proposal allowing Negative OID:

Year 1 (2.08)loss
Year 2 0.16
Year 3 0.09
Year 4 0.05
Year 5 0.02
Overall income (1.77)

ALTERNATIVE METHOD EXAMPLE

Examples:

Investment/Issue Price $8.97 Expected Yield 8.455%

Total expected return: $10.50

Example 1
Expected Cash Flows:
Year 0 (8.97)
Year 1 5.00
Year 2 2.50
Year 3 1.50
Year 4 1.00
Year 5 0.50

(Offset amounts in bold.)
Year 1
payments for year/total expected payments =
5/10.5 = .47
ratio multiplied by investment =
.47(8.97) = **4.27**
Year 2
2.5/10.5 = .23
.23(8.97) = **2.14**
Year 3
1.5/10.5 = .143
.143(8.97) = **1.28**
Year 4
1/10.5 = .095
.095(8.97) = **.85**
Year 5
.5/10.5 = .047
.047(8.97) = **.43**

[4.27 + 2.14 + 1.28 + .85 + .43 = 8.97]

<u>Example 2</u>

If the expected return is not updated, the holder won't recover its investment.

Actual Cash Flows:

Year 0	(8.97)
Year 1	5.00
Year 2	1.00
Year 3	0.60
Year 4	0.40
Year 5	0.20

Year 1
5/10.5 = .48
.48(8.97) = **4.27**
Year 2
1/10.5 = .095
.095(8.97) = **.85**
Year 3
.6/10.5 = .06
.06(8.97) = **.51**
Year 4
.4/10.5 = .04
.04(8.97) = **.34**
Year 5
.2/10.5 = .02
.02(8.97) = **.17**
[4.27 + .85 + .51 + .34 + .17 = 6.14]

<u>Example 3</u>

If you update the expected return after year 1:

Actual Cash Flows:

Year 0	(8.97)
Year 1	5.00
Year 2	1.00
Year 3	0.60
Year 4	0.40
Year 5	0.20

Year 1
5/10.5 = .48
.48(8.97) = **4.27**
After year 1, total expected return is 7.20 (5+1+.6+.4+.2):

Year 2
1/7.2 = .14
.14(8.97) = **1.25**
Year 3
.6/7.2 = .08
.08(8.97) = **.75**
Year 4
.4/7.2 = .06
.06(8.97) = **.50**
Year 5
.2/7.2 = .03
.03(8.97) = **.25**
[4.27 + 1.25 + .75 + .50 + .25 = 7.02]

If the holder recalculates Year 1, using the new total expected return ((5/7.2)(8.97)) = 6.23), and takes into account the difference between that amount (6.23) and the amount calculated using the original expected return (4.27), which equals 1.96, the holder will recover its total investment.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 24, 2004
js-1874

Treasury Employs USA PATRIOT Act Authorities to Designate Two Foreign Banks as "Primary Money Laundering Concerns"

In another step to protect the integrity of the U.S. financial system and identify rogue financial institutions, the U.S. Department of the Treasury today designated two foreign banks – First Merchant Bank of the "Turkish Republic of Northern Cyprus" ("TRNC") and Infobank of Belarus – as financial institutions of "primary money laundering concern," pursuant to Section 311 of the *USA PATRIOT Act*.

"We continue to use our authority under Section 311 of the *USA PATRIOT Act* to protect the U.S. financial system from corrupt financial institutions such as these," said Stuart Levey, Treasury's Under Secretary for Terrorism and Financial Intelligence. "Today's designation alerts the global financial community of the threat posed by these entities. It also serves notice to others that there will be significant consequences for institutions that launder tainted money or engage in similar corruption: we will cut you off from the U.S financial system."

In conjunction with this designation, Treasury's Financial Crimes Enforcement Network issued two Notices of Proposed Rulemaking (NPRM) imposing a special measure against the two banks that would prohibit covered financial institutions from establishing, maintaining, administering or managing in the any correspondent account in the United States for or on behalf of First Merchant Bank or Infobank. In addition, covered financial institutions would be required to apply special due diligence to their correspondent accounts to guard against their indirect use by First Merchant Bank or Infobank.

First Merchant Bank, which operates out of offices in Lefkosa/Nicosia, "TRNC," is a privately owned commercial bank specializing in the provision of commercial and investment banking services to individual and corporate offshore customers. First Merchant Bank is licensed as an offshore bank in the "TRNC," a jurisdiction with inadequate anti-money laundering controls, particularly those applicable to the jurisdiction's offshore sector.

First Merchant Bank is also involved in the marketing and sale of fraudulent financial products and services. The institution has been used as a conduit for the laundering of fraudulently obtained funds. In addition, the individuals who own, control, and operate First Merchant Bank have links with organized crime and apparently have used First Merchant Bank to launder criminal proceeds.

Infobank is a privately owned Belarusian bank that is licensed to engage in foreign exchange transactions. Infobank is being designated today for its complicity in laundering funds derived from fraudulent transactions involving Iraq. Infobank laundered funds for the former Iraqi regime of Saddam Hussein that were derived from schemes to circumvent the United Nations Oil-for-Food (OFF) program, including illegal surcharges and inflated contracts. These funds were then laundered through several other foreign banks and shell corporations. Finally, proceeds from the illegal surcharges and inflated contracts either were returned to the Iraqi government – in violation of OFF program conditions – or were used to purchase weapons or finance military training through Infobank and its subsidiary.

Title III of the *PATRIOT Act* amends the anti-money laundering provisions of the *Bank Secrecy Act* (BSA) to promote the prevention, detection and prosecution of international money laundering and the financing of terrorism. Section 311 authorizes the Secretary of the Treasury – in consultation with DOJ, the State

Department and appropriate Federal financial regulators – to designate a foreign jurisdiction, institution, class of transactions or type of account to be of "primary money laundering concern" and to require U.S. financial institutions to take certain "special measures" against the designee.

These special measures range from enhanced recordkeeping or reporting obligations to a requirement to terminate correspondent banking relationships with the designated entity. The measures are meant to provide Treasury with a range of options to most effectively target specific money laundering and terrorist financing

Most recently, the Treasury Department used the authority of Section 311 to designate the Commercial Bank of Syria (CBS) and its subsidiary Syrian Lebanese Commercial Bank and issued a notice of proposed rule-making that would prohibit any U.S. bank, broker-dealer, futures commission merchant, introducing broker or mutual fund from opening or maintaining a correspondent account for or on behalf of CBS. Correspondent accounts involving CBS would have to be terminated without exception.

Last November Treasury also authorized Section 311 against two Burmese banks, Myanmar Mayflower Bank and Asia Wealth Bank, two banks that within that jurisdiction that are heavily implicated in facilitating the notorious drug trafficking organizations in Southeast Asia. Since the *PATRIOT Act* was signed into law in October 2001, the Bush Administration has also taken action, pursuant to Section 311, against the foreign jurisdictions of Burma, Nauru and the Ukraine.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 25, 2004
JS-1875

Secretary Snow Visits Grand Rapids, Michigan on Friday

U.S. Treasury Secretary John W. Snow will visit Grand Rapids, Michigan on Friday, August 27 to meet with local business leaders and discuss the President's efforts to strengthen the economy and create jobs. He will be joined by Congressman Vernon Ehlers.

"As a result of the President's economic leadership, we have overcome a recession and seen 11 straight months of job creation, totaling nearly 1.5 million new U.S. jobs since August 2003," said Secretary Snow. "The President's tax reform policies have ensured that more than 3.6 million Michigan taxpayers will have lower income tax bills in 2004."

During this trip to Michigan, Secretary Snow also will discuss the Administration's efforts to control health care costs, reduce frivolous lawsuits and ensure that America has reliable and affordable sources of energy. "While the economy is on solid footing, we are not satisfied and there is still more work to be done. We need to continue to push for pro-growth policies that will create jobs and raise standards of living," Secretary Snow said.

Recent indicators show that President Bush's economic policies continue to move the economy forward. According to the Labor Department, the national unemployment rate declined to 5.5% in July – down 0.8 percentage point from a peak of 6.3% in June 2003 and the lowest rate since October 2001. At 5.5%, the unemployment rate is below the average of the 1970s, 1980s, and 1990s. Employment over the last year was up in 46 of the 50 states and the unemployment rate was down in all regions and in 47 of the 50 states.

The following events are open to the media, which must present media credentials or photo ID:

Friday, August 27

Meeting with Local Business Leaders
7:30 am EDT
Grand Rapids Chamber of Commerce
111 Pearl St., NW
Grand Rapids, MI
** Media should arrive by 7:00 am

Tour and Roundtable Discussion on Health Savings Accounts
10:00 am EDT
West Michigan Piano
3600 29th St., SE
Grand Rapids, MI
** Media should arrive by 9:30 am
** A brief press availability will occur immediately following the event

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 25, 2004
js-1876

Treasury Seeks Public Input in Development of National Strategy for Financial Education

Treasury's Office of Financial Education today announced a request for public comment on behalf of the Financial Literacy and Education Commission for development of the first-ever national strategy for financial education.

The Financial Literacy and Education Commission was established under Title V, the Financial Literacy and Education Improvement Act, which is part of the Fair and Accurate Credit Transactions Act of 2003 (P.L. 108-159). The Act calls for the establishment of a national financial education toll-free hotline and Web site, as well as the development of the country's first national strategy for financial education.

Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr. leads the Commission's efforts to develop the national strategy. "All across America, dedicated groups and individuals are working to meet our country's need for financial education," said Iannicola. "Through this request for comment, we hope to learn from those who are making a difference in their communities by using financial education to improve lives. We'll use their insights to craft a sound national strategy to raise our country's level of financial knowledge."

The request for comment was filed at the Federal Register and will be published on August 26, 2004.

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning. The office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. For more information about the Office of Financial Education visit: www.treas.gov/financialeducation.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 27, 2004
js-1877

Prepared Remarks by Treasury Secretary John Snow At West Michigan Piano Grand Rapids, MI

Good morning and thank you so much for having me here today. It's great to be back in Grand Rapids, a city that I have visited often over the years, and it's wonderful to visit West Michigan Piano. I wish my wife Carolyn could be with me today; she is the piano player in the Snow family and knowing of her love of fine pianos the visit would undoubtedly have been more expensive for me if she were here.

There is a lot of good news here at this company; I commend you on your success! Hard work and innovation has done for you what it has done for generations of American entrepreneurs: it has paid off for you, your associates, your customers, your suppliers and your community.

Today you are expanding your facilities and your reach. Your customers and suppliers will all benefit as a result. The American economy will benefit, too...and I'd like to talk more, later on today, about how critical businesses like this are to economic growth.

But perhaps the greatest beneficiary of any small-business success story is its employees.

When the business does well, an owner like Ken Wierenga is able to increase compensation for employees, add benefits, or even create new positions, which is great news for a community, a state and a country where workers need jobs.

And I know there is no greater feeling of success for a business owner than when one of their employees buys a new home, or maybe their first new car or is able to take that long dreamed of vacation. Success for those employees means everything to the person who started that business.

That's also why it is so frustrating for business owners who find themselves unable to afford health insurance for their employees - who find themselves squeezed by rising premiums.

Employees of a small or medium-sized firm are like extended family to the owner of the business. Many of them are actual family members. So when health insurance rates are rising steeply and becoming harder and harder to afford, a good business owner has many sleepless nights.

Ken has had his share of those sleepless nights, I know. But I'm delighted to say that a new law creating something called Health Savings Accounts (HSAs) is helping him get the rest he needs.

HSAs were created as part of the Presidents Medicare reform legislation. They are like super-charged IRAs that put patients back in charge of their health care. You own it, you control it, and you can leave it to your heirs.

One of the top benefits of HSAs is the fact that both employers and employees can save money by using them. And that's good news for the future of health coverage in this country. We need it to be more affordable so we can get more people covered.

I was delighted to learn that companies who offer HSAs are reporting to the Treasury Department that among those who sign up for the program, 25-40% of the enrollees were previously uninsured.

HSAs are a great start, a terrific new option for the small business community... but more must be done to address the rising cost of health care in this country. Health insurance premiums are acting as a drag on the small employers that mean so much to our economy.

Companies like West Michigan Piano - the small businesses on which our economy depends - create two-thirds of new private sector jobs in America. They employ more than half of all workers, and account for more than half of the output of our economy. That's why you'll often hear the President say: what's good for small business is good for America. Because when small business is growing, the American economy is growing.

The rising cost of health insurance is bad for the small-business community, and it impedes growth in the overall American economy.

Many small firms don't offer health insurance coverage because of the daunting cost. But that certainly isn't the outcome they want. They want to provide coverage because they care about their employees, they are their best asset... and they want to be able to offer it in order to attract the skilled workers they need to be competitive.

The President has called upon the Congress repeatedly to pass Association Health Plans, which would allow small-business owners and their employees to join together into larger groups to purchase health insurance. The savings to small business would be outstanding, and AHPs would provide another way for people like Ken and the employees of West Michigan Piano to save money on health insurance.

AHPs will provide small businesses the opportunity to band together through trade and professional associations to purchase affordable health benefits, giving them the greater bargaining power, economies of scale, and administrative efficiencies currently enjoyed by large employer and union plans. AHPs will level the playing field, giving small employers the same advantages as larger employers and unions.

AHP legislation is stalled in the U.S. Senate and that's a real shame. The Senate needs to act, without any further delay. The uninsured cannot wait any longer for reforms that will increase the availability and affordability of health insurance coverage. Small and family owned businesses ought to have the same advantages of the big firms. It's the right thing to do and the Senate needs to act now.

The Senate also needs to act to curb the abusive lawsuits that are directly contributing to these terribly high and rising health coverage costs.

As of 2002, 58 percent of physicians reported that they had been the target of a lawsuit, and their malpractice insurance typically rose between 30 and 75 percent over three years, from 2000 to 2002. The higher that malpractice insurance, the more doctors need to charge their patients to stay in business. Many doctors I know can't take it anymore. They have thrown in the towel. Retired early. Taken their life-saving abilities out of the medical system, because the risks of staying in are just too high, and because they've had enough.

Does anyone really believe that 58 percent of doctors are negligent? Of course not. Some small percentage of the members of any profession are going to fail to live up to the best standards of practice ... but when 58 percent of them are being sued...

well, that explains why the term "ambulance chaser" is part of our national vocabulary.

Legislation pending on Capitol Hill takes a common-sense approach to these problems and would go a long way toward protecting our health-care system from baseless suits that are ultimately robbing patients of the quality and convenience that they are paying dearly for.

The medical community is just one part of our economy that is hurt by baseless, abusive lawsuits. Everywhere I travel across America I hear the call from small business people for relief from these abusive lawsuits.

The threat of suits is a disincentive for hiring. And if a baseless suit is brought by a customer, employee or passer-by, small firms will often lose thousands of dollars by settling rather than going to court...because the cost of defending themselves would be even higher, and cash-flow is tight in a small firm.

This burden on America's job creators is the last thing we need in an economy that has seen very hard times, is in recovery and expansion now, and needs to create more good jobs for those who still seek work.

Our economy is incredibly resilient. It is more open, flexible and adaptive than any other in the world. And the most powerful elements of our economy are our small-business owners and entrepreneurs, our outstanding workforce, and the simple fact that we believe in free, open, competitive market.

The strength of our economy can be seen here today, at West Michigan Piano. This expanding business and its employees are a perfect example of what makes our economy tick.

That's why the President wants to keep Ken's taxes low. And that's why he wants to keep Ken's employees' taxes low. President Bush believes that Ken and his employees know best how to save and invest their own money.

The President understands that creating an environment in which America's innovators can flourish is the essential ingredient in any recipe for economic growth. Keeping taxes low gives businesses like this one room to grow.

The President's tax cuts allowed small-business owners like Ken to keep more of their business income, and encouraged them to invest in the growth of their companies. For example, nearly 725,000 business taxpayers in Michigan will save money on their 2004 taxes.

Similarly, the tax cuts have allowed individuals to keep more of their income. More than 3.6 million Michigan taxpayers will have lower income tax bills in 2004 thanks to the tax relief.

The results of letting people keep more of their own money, and spend it how they see fit, have helped put our nation on the right track. Nationwide, nearly 1.5 million jobs have been created since August 2003 according to the payroll survey; and 2.3 million jobs have been created since August 2003 according to the household survey. More people than ever before own their own homes, and new homes are being purchased every day. People are finding new jobs. They have more money in their pockets and can better afford things from cars to appliances to shoes for their children. That said, we are not satisfied. There is still more work to do.

The tax cuts were like oxygen for our economy. And we needed that oxygen badly; our economy was already in steep decline when the President took office. Then we were hit with the devastating blows of September 11th, the bursting of the stock market bubble and the corporate scandals. Those events literally kicked us when we were down. The tax cuts and the actions by the Federal Reserve gave our economy the stimulus it needed. Although we still face a lot of obstacles and won't be satisfied until every American and every Michigan worker who seeks work can

find it, our economy is once again on solid footing.

We have plenty of work to do - in Michigan and across America. But if we continue on the path of freedom and making sure individuals and entrepreneurs have an environment in which they can work and grow, our best economic days will remain ahead of us and I am optimistic about our future.

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PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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August 27, 2004
JS-1878

Treasury Issues Final Regulations on Certain Foreign Currency Instruments

Today the Treasury Department issued final regulations providing detailed rules on the tax treatment of contingent payment debt instruments denominated in one or more foreign currencies.

Existing regulations provide guidance on the tax treatment of non-contingent debt instruments denominated in a foreign currency, and on contingent payment debt instruments not denominated in any foreign currency. These final regulations fill the gap between the existing sets of rules.

The final regulations reflect modest changes that respond to comments received on the proposed regulations. The final regulations follow the proposed regulations' general approach of applying the "non-contingent bond method" under section 1275 to a debt instrument in the instrument's denomination currency. The resulting amounts are then translated into the taxpayer's functional currency, and gain or loss is determined, under rules similar to the existing rules for non-contingent debt instruments that are denominated in a foreign currency.

The final regulations apply to debt instruments issued 60 or more days after the regulations are published in the Federal Register.

The text of the final regulations is attached.

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REPORTS

- The text of the final regulations

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9157]

RIN 1545-AW33

Guidance Regarding the Treatment of Certain Contingent Payment Debt Instruments with One or More Payments that Are Denominated in, or Determined by Reference to, a Nonfunctional Currency

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations regarding the treatment of contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a currency other than the taxpayer's functional currency. These regulations are necessary because current regulations do not provide guidance concerning the tax treatment of such instruments. The regulations affect issuers and holders of such instruments.

DATES: Effective Date: These regulations are effective August 30, 2004.

Applicability date: These regulations apply to debt instruments issued on or after October 29, 2004.

FOR FURTHER INFORMATION CONTACT: Milton Cahn, (202) 622-3860 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1831. Responses to these collections of information are mandatory.

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

The estimated annual burden per [respondent/recordkeeper] varies from 48 minutes to 1 hour 12 minutes, depending on individual circumstances, with an estimated average of 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP Washington, DC 20224, and 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.

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

Background

This document contains amendments to 26 CFR part 1. On August 29, 2003, a notice of proposed rulemaking (REG-106486-98) relating to the taxation of nonfunctional currency denominated contingent payment debt instruments was published in the **Federal Register** (68 FR 51944). No public hearing was requested or held. One written comment responding to the notice of proposed rulemaking was received. After consideration of this comment, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Summary of Comments

Treasury and the IRS received one comment letter in response to the notice of proposed rulemaking. The issues raised in that comment letter are addressed below.

1. Exceptions Described in §1.1275-4(a)(2)

The comment letter notes that in describing instruments subject to §1.988-6 by reference to §1.1275-4(b)(1), it was

unclear whether the exceptions set forth in §1.1275-4(a)(2) applied to instruments described in §1.988-6(a)(1).

It was intended to be implicit from the reference to §1.1275-4(b)(1) that debt instruments excluded from the application of §1.1275-4 by reason of §1.1275-4(a)(2) (other than by reason of being subject to section 988) are similarly excluded from §1.988-6. Nevertheless, the final regulations have been revised to make explicit that §1.988-6 applies only to debt instruments to which §1.1275-4 would otherwise apply (not taking into account the exclusion for debt instruments that are subject to section 988).

2. Multicurrency Debt Instruments With Related Hedges

The comment letter expresses concern that it may be possible to structure arrangements to avoid the original issue discount (OID) rules using a multicurrency debt instrument that has a nonfunctional currency as the predominant currency and partial hedges of that instrument. That is, it may be possible to closely replicate the economic attributes of a dollar denominated instrument with OID through a combination of a multicurrency instrument without OID and a partial hedge of that instrument. The comment letter suggests that §1.988-5(a) would not apply in such a case, because the hedge would not be a complete hedge of all payments.

Treasury and the IRS believe that an anti-abuse rule is appropriate to prevent the potential abuse described above. Accordingly, an anti-abuse rule applicable to debt instruments subject to section 988 is included in §1.988-2(b)(18). This anti-abuse rule is patterned after the anti-abuse rule contained in §1.1275-2(g) and permits the Commissioner to apply or depart from the applicable regulations as necessary or appropriate to achieve a reasonable result. No inference is intended as to how the Commissioner may apply the anti-abuse rule contained in §1.1275-2(g) to nonfunctional currency denominated debt instruments.

In addition, Treasury and the IRS believe that §1.988-2(f) may be applied in the situation described. Furthermore, Treasury and the IRS note that under §1.988-5(a)(8)(iii) the Commissioner can integrate a foreign currency denominated debt instrument with a partial hedge of that instrument.

3. Multicurrency Debt Instrument--Determination of Predominant Currency

The comment letter proposes the use of a special anti-abuse rule in the case where the net present value of all payments in, or determined with respect to, the predominant currency of a multicurrency instrument does not exceed 50 percent of the present value of all payments. The letter requests that, in such a case, the comparable yield be determined on a synthetic

basis by reference to the weighted average of the comparable yields in each component currency rather than by reference to the predominant currency. There are two stated rationales for this request. First, the holder could avoid accrual of OID if a multicurrency contingent payment debt instrument's predominant currency is a currency with a low interest rate and the other currencies in which payments are denominated or with respect to which payments are determined are highly inflationary currencies (but not hyperinflationary currencies). Second, if the predominant low interest rate currency in such an instrument is the U.S. dollar and the issuer is foreign, a holder's gain upon disposition of the instrument would be characterized as foreign source interest income rather than as U.S. source foreign currency gain.

Treasury and the IRS agree that the letter has identified an issue to be addressed. However, Treasury and the IRS believe the proposed solution of creating a synthetic yield (and presumably a synthetic currency to measure currency gain or loss) is overly complex and would be difficult to administer. Instead, Treasury and the IRS have added a special rule that applies if there is no single currency for which the net present value in functional currency of all payments denominated in, or determined by reference to, that currency is greater than 50

percent of the total value of all payments. In such a case, if the discount rate attributable to the currency that would otherwise be the predominant currency differs by 10 percentage points or more from the discount rate attributable to any other currency in which payments are denominated or with respect to which payments are determined, the Commissioner can determine the predominant currency under any reasonable method.

4. Integrated Debt Instruments

The comment letter requests clarification that §1.988-6 does not apply to transactions that are composed of a nonfunctional currency contingent payment debt instrument (or a multicurrency debt instrument) and a qualified hedge and that are subject to the integration rules of §1.988-5. Treasury and the IRS believe that the proposed regulations are clear on this point, because §1.988-5(a)(5)(i) provides that a taxpayer may treat a debt instrument and a hedge as an integrated economic transaction only if, among other things, all the contingent features of an instrument are fully hedged such that the synthetic debt instrument resulting from integration is not a contingent payment instrument. Accordingly, no change has been made in the final regulations regarding this issue.

5. Alternative Payment Schedule and Fixed Yield Rules

Section 1.1275-4(a)(2)(iii) provides that the contingent payment debt instrument rules in §1.1275-4 do not apply to a debt instrument subject to §1.1272-1(c) (a debt instrument that provides for certain alternative payment schedules) or §1.1272-1(d) (a debt instrument that provides for a fixed yield). The comment letter requests that the final regulations clarify that, for purposes of applying §§1.1272-1(c) and 1.1272-1(d) to a nonfunctional currency denominated debt instrument, the yield of the instrument be determined in the instrument's denomination currency, rather than in the taxpayer's functional currency. Treasury and the IRS believe that it is clear under §1.988-2(b)(2)(ii)(A) (determinations regarding OID in a nonfunctional currency denominated debt instrument are made in the currency of the debt instrument) that these provisions are applied by using the debt instrument's denomination currency. Accordingly, no change has been made in the final regulations regarding this issue.

6. Predominant Currency of a Multicurrency Debt Instrument is the Same as the Taxpayer's Functional Currency

The comment letter requests that the final regulations clarify that if the predominant currency of a multicurrency debt instrument is the taxpayer's functional currency, then section 988 does not apply to that instrument. Treasury and the IRS believe that §1.988-6(d)(4) of the proposed regulations is clear

on this point. Accordingly, no further clarification is made in the final regulations.

7. Other Regulatory Provisions

The comment letter requests that the final regulations clarify that debt instruments subject to §1.988-6 be treated for purposes of other regulations as if they were subject to §1.1275-4. Section 1.988-6 provides that the rules of §1.1275-4 apply to debt instruments subject to §1.988-6, except as otherwise provided in §1.988-6. Accordingly, a reference to a debt instrument subject to §1.1275-4 will also refer to a debt instrument subject to §1.988-6, unless otherwise provided in §1.988-6. Treasury and the IRS therefore believe that no further clarification is necessary.

8. Netting Currency Gain or Loss With Other Gain or Loss Upon a Disposition of the Instrument

In response to a request in the preamble to the proposed regulations for comments regarding netting, the comment letter proposes that foreign currency gain or loss be netted with other gain or loss on the disposition of a debt instrument. Treasury and the IRS are concerned about this type of netting in the context of foreign currency contingent payment debt instruments. Depending on the particular terms of such an instrument, a change in value due to a contingency may be recognized for tax purposes in a year prior to the recognition of foreign currency

gain or loss upon disposition of the instrument or may be recognized concurrently with the recognition of foreign currency gain or loss upon disposition. Treasury and the IRS therefore have concluded that netting is not appropriate in the context of foreign currency contingent payment debt instruments.

9. Tax Exempt Foreign Currency Contingent Payment Debt Instruments

In response to a request in the preamble to the proposed regulations for comments regarding tax exempt foreign currency contingent payment debt instruments, the comment letter requests certain modifications to §1.1275-4(d)(3) to take into account the policy considerations underlying §1.988-3(c). Treasury and the IRS appreciate these comments but believe the matter deserves more careful study before any regulations specifically addressing tax exempt foreign currency contingent payment debt instruments can be issued.

10. Multicurrency Debt Instruments With no Non-Currency Contingencies

In response to the request for comments contained in the preamble to the proposed regulations, the comment letter requests that all gain or loss on a sale of a multicurrency debt instrument that has no non-currency contingencies be characterized wholly as foreign currency gain or loss. Treasury and the IRS are concerned that such treatment would differ

inappropriately from the treatment of gain or loss in respect of a contingent payment debt instrument that has currency contingencies and non-currency contingencies. Accordingly, no change has been made in the final regulations regarding this issue.

Effect on Other Documents

The following publications are obsolete with regard to debt instruments issued on or after October 29, 2004:

Announcement 99-76, 1999-2 C.B. 223.

Special Analyses

It has been determined that this final regulation 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. This certification is based upon the fact that few, if any, small entities issue or hold foreign currency denominated contingent payment debt instruments. Generally, it is expected that the only domestic holders of these instruments will likely be financial institutions, investment banking firms, investment funds, and other sophisticated investors, due to the foreign currency risk and other contingencies inherent in these instruments. Therefore, a Regulatory Flexibility Analysis under

the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to 26 U.S.C. 7805(f), the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Milton Cahn of the Office of the Associate Chief Counsel (International). 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 602

Reporting and recordkeeping requirements.

Adoption of 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 1.988-0 is amended as follows:

1. The introductory text is revised.

2. Entries are added for §§1.988-2(b)(18), 1.988-2(h) and 1.988-6.

The revision and additions read as follows:

§1.988-0 Taxation of gain or loss from a section 988 transaction; Table of contents

This section lists captioned paragraphs contained in §§1.988-1 through 1.988-6.

* * * * *

§1.988-2 Recognition and computation of exchange gain or loss.

* * * * *
(b) * * *
(18) Interaction of section 988 and §1.1275-2(g).
* * * * *
(h) Timing of income and deductions from notional principal contracts.
* * * * *

§1.988-6 Nonfunctional currency contingent payment debt instruments.

(a) In general.
(1) Scope.
(2) Exception for hyperinflationary currencies.
(b) Instruments described in paragraph (a)(1)(i) of this section.
(1) In general.
(2) Application of noncontingent bond method.
(3) Treatment and translation of amounts determined under noncontingent bond method.
(4) Determination of gain or loss not attributable to foreign currency.
(5) Determination of foreign currency gain or loss.
(6) Source of gain or loss.
(7) Basis different from adjusted issue price.
(8) Fixed but deferred contingent payments.
(c) Examples.
(d) Multicurrency debt instruments.

(1) In general.
(2) Determination of denomination currency.
(3) Issuer/holder consistency.
(4) Treatment of payments in currencies other than the denomination currency.
(e) Instruments issued for nonpublicly traded property.
(1) Applicability.
(2) Separation into components.
(3) Treatment of components consisting of one or more noncontingent payments in the same currency.
(4) Treatment of components consisting of contingent payments.
(5) Basis different from adjusted issue price.
(6) Treatment of holder on sale, exchange, or retirement.
(f) Rules for nonfunctional currency tax exempt obligations described in §1.1275-4(d).
(g) Effective date.

Par. 3. Section 1.988-2 is amended by:

1. Adding the text of paragraph (b)(2)(i)(B)(1).

2. Revising paragraph (b)(2)(i)(B)(2).

3. Adding the text of paragraph (b)(18).

The additions and revision read as follows:

'1.988-2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(B) * * * (1) Operative rules. See '1.988-6 for rules applicable to contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a nonfunctional currency.

(2) Certain instruments are not contingent payment debt instruments. For purposes of sections 163(e) and 1271 through 1275 and the regulations thereunder, a debt instrument does not provide for contingent payments merely because the instrument is denominated in, or all payments of which are determined with reference to, a single nonfunctional currency. See §1.988-6 for the treatment of nonfunctional currency contingent payment debt instruments.

* * * * *

(18) Interaction of section 988 and §1.1275-2(g)--(i) In general. If a principal purpose of structuring a debt instrument subject to section 988 and any related hedges is to achieve a result that is unreasonable in light of the purposes of section 163(e), section 988, sections 1271 through 1275, or any related section of the Internal Revenue Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (b)(18) applies to a multicurrency debt instrument and a hedge or hedges, the Commissioner can wholly or partially integrate transactions or treat portions of the debt instrument as separate instruments where appropriate. See also §1.1275-2(g).

(ii) Unreasonable result. Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. Another significant fact is whether the result is obtainable without the application of §1.988-6 and any related provisions (e.g., if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(iii) Effective date. This paragraph (b)(18) shall apply to debt instruments issued on or after October 29, 2004.

* * * * *

Par. 4. Section 1.988-6 is added to read as follows:

'1.988-6 Nonfunctional currency contingent payment debt instruments.

(a) In general--(1) Scope. This section determines the accrual of interest and the amount, timing, source, and character of any gain or loss on nonfunctional currency contingent payment debt instruments described in this paragraph (a)(1) and to which §1.1275-4(a) would otherwise apply if the debt instrument were denominated in the taxpayer's functional

currency. Except as provided by the rules in this section, the rules in '1.1275-4 (relating to contingent payment debt instruments) apply to the following instruments--

(i) A debt instrument described in '1.1275-4(b)(1) for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which has one or more non-currency related contingencies;

(ii) A debt instrument described in '1.1275-4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has no non-currency related contingencies;

(iii) A debt instrument described in '1.1275-4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has one or more non-currency related contingencies; and

(iv) A debt instrument otherwise described in paragraph (a)(1)(i), (ii) or (iii) of this section, except that the debt instrument is described in '1.1275-4(c)(1) rather than '1.1275-4(b)(1) (e.g., the instrument is issued for non-publicly traded property).

(2) Exception for hyperinflationary currencies--(i) In general. Except as provided in paragraph (a)(2)(ii) of this section, this section shall not apply to an instrument described

in paragraph (a)(1) of this section if any payment made under such instrument is determined by reference to a hyperinflationary currency, as defined in '1.985-1(b)(2)(ii)(D). In such case, the amount, timing, source and character of interest, principal, foreign currency gain or loss, and gain or loss relating to a non-currency contingency shall be determined under the method that reflects the instrument=s economic substance.

(ii) Discretion as to method. If a taxpayer does not account for an instrument described in paragraph (a)(2)(i) of this section in a manner that reflects the instrument=s economic substance, the Commissioner may apply the rules of this section to such an instrument or apply the principles of '1.988-2(b)(15), reasonably taking into account the contingent feature or features of the instrument.

(b) Instruments described in paragraph (a)(1)(i) of this section--(1) In general. Paragraph (b)(2) of this section provides rules for applying the noncontingent bond method (as set forth in '1.1275-4(b)) in the nonfunctional currency in which a debt instrument described in paragraph (a)(1)(i) of this section is denominated, or by reference to which its payments are determined (the denomination currency). Paragraph (b)(3) of this section describes how amounts determined in paragraph

(b)(2) of this section shall be translated from the denomination currency of the instrument into the taxpayer=s functional currency. Paragraph (b)(4) of this section describes how gain or loss (other than foreign currency gain or loss) shall be determined and characterized with respect to the instrument. Paragraph (b)(5) of this section describes how foreign currency gain or loss shall be determined with respect to accrued interest and principal on the instrument. Paragraph (b)(6) of this section provides rules for determining the source and character of any gain or loss with respect to the instrument. Paragraph (b)(7) of this section provides rules for subsequent holders of an instrument who purchase the instrument for an amount other than the adjusted issue price of the instrument. Paragraph (c) of this section provides examples of the application of paragraph (b) of this section. See paragraph (d) of this section for the determination of the denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section. See paragraph (e) of this section for the treatment of an instrument described in paragraph (a)(1)(iv) of this section.

(2) Application of noncontingent bond method--(i) Accrued interest. Interest accruals on an instrument described in paragraph (a)(1)(i) of this section are initially determined in

the denomination currency of the instrument by applying the noncontingent bond method, set forth in '1.1275-4(b), to the instrument in its denomination currency. Accordingly, the comparable yield, projected payment schedule, and comparable fixed rate debt instrument, described in '1.1275-4(b)(4), are determined in the denomination currency. For purposes of applying the noncontingent bond method to instruments described in this paragraph, the applicable Federal rate described in '1.1275-4(b)(4)(i) shall be the rate described in '1.1274-4(d) with respect to the denomination currency.

(ii) Net positive and negative adjustments. Positive and negative adjustments, and net positive and net negative adjustments, with respect to an instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of '1.1275-4(b)(6) (and '1.1275-4(b)(9)(i) and (ii), if applicable) in the denomination currency. Accordingly, a net positive adjustment is treated as additional interest (in the denomination currency) on the instrument. A net negative adjustment first reduces interest that otherwise would be accrued by the taxpayer during the current tax year in the denomination currency. If a net negative adjustment exceeds the interest that would otherwise be accrued by the taxpayer during the current tax year in the denomination currency, the excess is

treated as ordinary loss (if the taxpayer is a holder of the instrument) or ordinary income (if the taxpayer is the issuer of the instrument). The amount treated as ordinary loss by a holder with respect to a net negative adjustment is limited, however, to the amount by which the holder=s total interest inclusions on the debt instrument (determined in the denomination currency) exceed the total amount of the holder=s net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years (determined in the denomination currency). Similarly, the amount treated as ordinary income by an issuer with respect to a net negative adjustment is limited to the amount by which the issuer=s total interest deductions on the debt instrument (determined in the denomination currency) exceed the total amount of the issuer=s net negative adjustments treated as ordinary income on the debt instrument in prior taxable years (determined in the denomination currency). To the extent a net negative adjustment exceeds the current year=s interest accrual and the amount treated as ordinary loss to a holder (or ordinary income to the issuer), the excess is treated as a negative adjustment carryforward, within the meaning of '1.1275-4(b)(6)(iii)(C), in the denomination currency.

(iii) Adjusted issue price. The adjusted issue price of an instrument described in paragraph (a)(1)(i) of this section is

determined by applying the rules of '1.1275-4(b)(7) in the denomination currency. Accordingly, the adjusted issue price is equal to the debt instrument=s issue price in the denomination currency, increased by the interest previously accrued on the debt instrument (determined without regard to any net positive or net negative adjustments on the instrument) and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument. All adjustments to the adjusted issue price are calculated in the denomination currency.

(iv) Adjusted basis. The adjusted basis of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of '1.1275-4(b)(7) in the taxpayer=s functional currency. In accordance with those rules, a holder=s basis in the debt instrument is increased by the interest previously accrued on the debt instrument (translated into functional currency), without regard to any net positive or net negative adjustments on the instrument (except as provided in paragraph (b)(7) or (8) of this section, if applicable), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument to the holder (translated into functional

currency). See paragraph (b)(3)(iii) of this section for translation rules.

(v) Amount realized. The amount realized by a holder and the repurchase price paid by the issuer on the scheduled or unscheduled retirement of a debt instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of '1.1275-4(b)(7) in the denomination currency. For example, with regard to a scheduled retirement at maturity, the holder is treated as receiving the projected amount of any contingent payment due at maturity, reduced by the amount of any negative adjustment carryforward. For purposes of translating the amount realized by the holder into functional currency, the rules of paragraph (b)(3)(iv) of this section shall apply.

(3) Treatment and translation of amounts determined under noncontingent bond method--(i) Accrued interest. The amount of accrued interest, determined under paragraph (b)(2)(i) of this section, is translated into the taxpayer=s functional currency at the average exchange rate, as described in '1.988-2(b)(2)(iii)(A), or, at the taxpayer's election, at the appropriate spot rate, as described in '1.988-2(b)(2)(iii)(B).

(ii) Net positive and negative adjustments--(A) Net positive adjustments. A net positive adjustment, as referenced in paragraph (b)(2)(ii) of this section, is translated into the

taxpayer=s functional currency at the spot rate on the last day of the taxable year in which the adjustment is taken into account under '1.1275-4(b)(6), or, if earlier, the date the instrument is disposed of or otherwise terminated.

(B) Net negative adjustments. A net negative adjustment is treated and, where necessary, is translated from the denomination currency into the taxpayer=s functional currency under the following rules:

(1) The amount of a net negative adjustment determined in the denomination currency that reduces the current year=s interest in that currency shall first reduce the current year=s accrued but unpaid interest, and then shall reduce the current year=s interest which was accrued and paid. No translation is required.

(2) The amount of a net negative adjustment treated as ordinary income or loss under '1.1275-4(b)(6)(iii)(B) first is attributable to accrued but unpaid interest accrued in prior taxable years. For this purpose, the net negative adjustment shall be treated as attributable to any unpaid interest accrued in the immediately preceding taxable year, and thereafter to unpaid interest accrued in each preceding taxable year. The amount of the net negative adjustment applied to accrued but unpaid interest is translated into functional currency at the

same rate used, in each of the respective prior taxable years, to translate the accrued interest.

(3) Any amount of the net negative adjustment remaining after the application of paragraphs (b)(3)(ii)(B)(1) and (2) of this section is attributable to interest accrued and paid in prior taxable years. The amount of the net negative adjustment applied to such amounts is translated into functional currency at the spot rate on the date the debt instrument was issued or, if later, acquired.

(4) Any amount of the net negative adjustment remaining after application of paragraphs (b)(3)(ii)(B)(1), (2) and (3) of this section is a negative adjustment carryforward, within the meaning of '1.1275-4(b)(6)(iii)(C). A negative adjustment carryforward is carried forward in the denomination currency and is applied to reduce interest accruals in subsequent years. In the year in which the instrument is sold, exchanged or retired, any negative adjustment carryforward not applied to interest reduces the holder=s amount realized on the instrument (in the denomination currency). An issuer of a debt instrument described in paragraph (a)(1)(i) of this section who takes into income a negative adjustment carryforward (that is not applied to interest) in the year the instrument is retired, as described in

'1.1275-4(b)(6)(iii)(C), translates such income into functional currency at the spot rate on the date the instrument was issued.

(iii) Adjusted basis--(A) In general. Except as otherwise provided in this paragraph and paragraph (b)(7) or (8) of this section, a holder determines and maintains adjusted basis by translating the denomination currency amounts determined under '1.1275-4(b)(7)(iii) into functional currency as follows:

(1) The holder=s initial basis in the instrument is determined by translating the amount paid by the holder to acquire the instrument (in the denomination currency) into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(2) An increase in basis attributable to interest accrued on the instrument is translated at the rate applicable to such interest under paragraph (b)(3)(i) of this section.

(3) Any noncontingent payment and the projected amount of any contingent payments determined in the denomination currency that decrease the holder=s basis in the instrument under '1.1275-4(b)(7)(iii) are translated as follows:

(i) The payment first is attributable to the most recently accrued interest to which prior amounts have not already been attributed. The payment is translated into functional currency at the rate at which the interest was accrued.

(ii) Any amount remaining after the application of paragraph (b)(3)(iii)(A)(3)(i) of this section is attributable to principal. Such amounts are translated into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(B) Exception for interest reduced by a negative adjustment carryforward. Solely for purposes of this '1.988-6, any amounts of accrued interest income that are reduced as a result of a negative adjustment carryforward shall be treated as principal and translated at the spot rate on the date the instrument was issued or, if later, acquired.

(iv) Amount realized--(A) Instrument held to maturity--(1) In general. With respect to an instrument held to maturity, a holder translates the amount realized by separating such amount in the denomination currency into the component parts of interest and principal that make up adjusted basis prior to translation under paragraph (b)(3)(iii) of this section, and translating each of those component parts of the amount realized at the same rate used to translate the respective component parts of basis under paragraph (b)(3)(iii) of this section. The amount realized first shall be translated by reference to the component parts of basis consisting of accrued interest during the taxpayer=s holding period as determined under paragraph

(b)(3)(iii) of this section and ordering such amounts on a last in first out basis. Any remaining portion of the amount realized shall be translated by reference to the rate used to translate the component of basis consisting of principal as determined under paragraph (b)(3)(iii) of this section.

(2) Subsequent purchases at discount and fixed but deferred contingent payments. For purposes of this paragraph (b)(3)(iv) of this section, any amount which is required to be added to adjusted basis under paragraph (b)(7) or (8) of this section shall be treated as additional interest which was accrued on the date the amount was added to adjusted basis. To the extent included in amount realized, such amounts shall be translated into functional currency at the same rates at which they were translated for purposes of determining adjusted basis. See paragraphs (b)(7)(iv) and (b)(8) of this section for rules governing the rates at which the amounts are translated for purposes of determining adjusted basis.

(B) Sale, exchange, or unscheduled retirement--(1) Holder. In the case of a sale, exchange, or unscheduled retirement, application of the rule stated in paragraph (b)(3)(iv)(A) of this section shall be as follows. The holder=s amount realized first shall be translated by reference to the principal component of basis as determined under paragraph (b)(3)(iii) of

this section, and then to the component of basis consisting of accrued interest as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a first in first out basis. Any gain recognized by the holder (i.e., any excess of the sale price over the holder=s basis, both expressed in the denomination currency) is translated into functional currency at the spot rate on the payment date.

(2) Issuer. In the case of an unscheduled retirement of the debt instrument, any excess of the adjusted issue price of the debt instrument over the amount paid by the issuer (expressed in denomination currency) shall first be attributable to accrued unpaid interest, to the extent the accrued unpaid interest had not been previously offset by a negative adjustment, on a last-in-first-out basis, and then to principal. The accrued unpaid interest shall be translated into functional currency at the rate at which the interest was accrued. The principal shall be translated at the spot rate on the date the debt instrument was issued.

(C) Effect of negative adjustment carryforward with respect to the issuer. Any amount of negative adjustment carryforward treated as ordinary income under '1.1275-4(b)(6)(iii)(C) shall be translated at the exchange rate on the day the debt instrument was issued.

(4) Determination of gain or loss not attributable to foreign currency. A holder of a debt instrument described in paragraph (a)(1)(i) of this section shall recognize gain or loss upon sale, exchange, or retirement of the instrument equal to the difference between the amount realized with respect to the instrument, translated into functional currency as described in paragraph (b)(3)(iv) of this section, and the adjusted basis in the instrument, determined and maintained in functional currency as described in paragraph (b)(3)(iii) of this section. The amount of any gain or loss so determined is characterized as provided in '1.1275-4(b)(8), and sourced as provided in paragraph (b)(6) of this section.

(5) Determination of foreign currency gain or loss--(i) In general. Other than in a taxable disposition of the debt instrument, foreign currency gain or loss is recognized with respect to a debt instrument described in paragraph (a)(1)(i) of this section only when payments are made or received. No foreign currency gain or loss is recognized with respect to a net positive or negative adjustment, as determined under paragraph (b)(2)(ii) of this section (except with respect to a positive adjustment described in paragraph (b)(8) of this section). As described in this paragraph (b)(5), foreign currency gain or loss is determined in accordance with the rules of '1.988-2(b).

(ii) Foreign currency gain or loss attributable to accrued interest. The amount of foreign currency gain or loss recognized with respect to payments of interest previously accrued on the instrument is determined by translating the amount of interest paid or received into functional currency at the spot rate on the date of payment and subtracting from such amount the amount determined by translating the interest paid or received into functional currency at the rate at which such interest was accrued under the rules of paragraph (b)(3)(i) of this section. For purposes of this paragraph, the amount of any payment that is treated as accrued interest shall be reduced by the amount of any net negative adjustment treated as ordinary loss (to the holder) or ordinary income (to the issuer), as provided in paragraph (b)(2)(ii) of this section. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iii) Principal. The amount of foreign currency gain or loss recognized with respect to payment or receipt of principal is determined by translating the amount paid or received into functional currency at the spot rate on the date of payment or receipt and subtracting from such amount the amount determined by translating the principal into functional currency at the spot rate on the date the instrument was issued or, in case of the

holder, if later, acquired. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iv) Payment ordering rules--(A) In general. Except as provided in paragraph (b)(5)(iv)(B) of this section, payments with respect to an instrument described in paragraph (a)(1)(i) of this section shall be treated as follows:

(1) A payment shall first be attributable to any net positive adjustment on the instrument that has not previously been taken into account.

(2) Any amount remaining after applying paragraph (b)(5)(iv)(A)(1) of this section shall be attributable to accrued but unpaid interest, remaining after reduction by any net negative adjustment, and shall be attributable to the most recent accrual period to the extent prior amounts have not already been attributed to such period.

(3) Any amount remaining after applying paragraphs (b)(5)(iv)(A)(1) and (2) of this section shall be attributable to principal. Any interest paid in the current year that is reduced by a net negative adjustment shall be considered a payment of principal for purposes of determining foreign currency gain or loss.

(B) Special rule for sale or exchange or unscheduled retirement. Payments made or received upon a sale or exchange or unscheduled retirement shall first be applied against the principal of the debt instrument (or in the case of a subsequent purchaser, the purchase price of the instrument in denomination currency) and then against accrued unpaid interest (in the case of a holder, accrued while the holder held the instrument).

(C) Subsequent purchaser that has a positive adjustment allocated to a daily portion of interest. A positive adjustment that is allocated to a daily portion of interest pursuant to paragraph (b)(7)(iv) of this section shall be treated as interest for purposes of applying the payment ordering rule of this paragraph (b)(5)(iv).

(6) Source of gain or loss. The source of foreign currency gain or loss recognized with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to '1.988-4. Consistent with the rules of '1.1275-4(b)(8), all gain (other than foreign currency gain) on an instrument described in paragraph (a)(1)(i) of this section is treated as interest income for all purposes. The source of an ordinary loss (other than foreign currency loss) with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to '1.1275-4(b)(9)(iv). The source

of a capital loss with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to '1.865-1(b)(2).

(7) Basis different from adjusted issue price--(i) In general. The rules of '1.1275-4(b)(9)(i), except as set forth in this paragraph (b)(7), shall apply to an instrument described in paragraph (a)(1)(i) of this section purchased by a subsequent holder for more or less than the instrument=s adjusted issue price.

(ii) Determination of basis. If an instrument described in paragraph (a)(1)(i) of this section is purchased by a subsequent holder, the subsequent holder=s initial basis in the instrument shall equal the amount paid by the holder to acquire the instrument, translated into functional currency at the spot rate on the date of acquisition.

(iii) Purchase price greater than adjusted issue price. If the purchase price of the instrument (determined in the denomination currency) exceeds the adjusted issue price of the instrument, the holder shall, consistent with the rules of '1.1275-4(b)(9)(i)(B), reasonably allocate such excess to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the excess shall be reasonably allocated over the remaining term of the

instrument to the daily portions of interest accrued and shall be a negative adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder=s adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the rate used to translate the interest which is offset by the negative adjustment. To the extent related to a projected payment, such excess shall be treated as a negative adjustment on the date the payment is made. On the date of such adjustment, the holder=s adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the spot rate on the date the instrument was acquired.

(iv) Purchase price less than adjusted issue price. If the purchase price of the instrument (determined in the denomination currency) is less than the adjusted issue price of the instrument, the holder shall, consistent with the rules of '1.1275-4(b)(9)(i)(C), reasonably allocate the difference to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the difference shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a positive adjustment on the dates

the daily portions accrue. On the date of such adjustment, the holder=s adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the rate used to translate the interest to which it relates. For purposes of determining adjusted basis under paragraph (b)(3)(iii) of this section, such increase in adjusted basis shall be treated as an additional accrual of interest during the period to which the positive adjustment relates. To the extent related to a projected payment, such difference shall be treated as a positive adjustment on the date the payment is made. On the date of such adjustment, the holder=s adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the spot rate on the date the adjustment is taken into account. For purposes of determining the amount realized on the instrument in functional currency under paragraph (b)(3)(iv) of this section, amounts attributable to the excess of the adjusted issue price of the instrument over the purchase price of the instrument shall be translated into functional currency at the same rate at which the corresponding adjustments are taken into account under this paragraph (b)(7)(iv) for purposes of determining the adjusted basis of the instrument.

(8) Fixed but deferred contingent payments. In the case of an instrument with a contingent payment that becomes fixed as to amount before the payment is due, the rules of '1.1275-4(b)(9)(ii) shall be applied in the denomination currency of the instrument. For this purpose, foreign currency gain or loss shall be recognized on the date payment is made or received with respect to the instrument under the principles of paragraph (b)(5) of this section. Any increase or decrease in basis required under '1.1275-4(b)(9)(ii)(D) shall be taken into account at the same exchange rate as the corresponding net positive or negative adjustment is taken into account.

(c) Examples. The provisions of paragraph (b) of this section may be illustrated by the following examples. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. The examples are as follows:

Example 1. Treatment of net positive adjustment--(i) Facts. On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a zero-coupon debt instrument with a non-currency contingency for ,1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to '1.1275-4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under paragraph (b)(2)(i) of this section and '1.1275-4(b), is 10 percent, compounded annually, and the

projected payment schedule, as constructed under the rules of '1.1275-4(b), provides for a single payment of ,1210 on December 31, 2006 (consisting of a noncontingent payment of ,975 and a projected payment of ,235). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in '1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is ,1300. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	,1.00=$ 1.00
Dec. 31, 2005	,1.00=$ 1.10
Dec. 31, 2006	,1.00=$ 1.20

Accrual period	Average rate (pounds to dollars)
2005	,1.00=$ 1.05
2006	,1.00=$ 1.15

(ii) Treatment in 2005--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues ,100 of interest on the debt instrument for 2005 (issue price of ,1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the ,100 at the average exchange rate for the accrual period ($1.05 x ,100 = $105). Accordingly, Z has interest income in 2005 of $105.

(B) Adjusted issue price and basis. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is ,1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 x ,1000 original cost basis) is increased by the ,100 of accrued interest, translated at the rate at which interest was accrued for 2005. See paragraph (b)(3)(iii) of this

section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2006, is $1105.

(iii) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues ,110 of interest on the debt instrument for 2006 (adjusted issue price of ,1100 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the ,110 at the average exchange rate for the accrual period ($1.15 x ,110 = $126.50). Accordingly, Z has interest income in 2006 of $126.50.

(B) Effect of net positive adjustment. The payment actually made on December 31, 2006, is ,1300, rather than the projected ,1210. Under paragraph (b)(2)(ii) of this section, Z has a net positive adjustment of ,90 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(3)(ii)(A) of this section, the ,90 net positive adjustment is treated as additional interest income and is translated into dollars at the spot rate on the last day of the year ($1.20 x ,90 = $108). Accordingly, Z has a net positive adjustment of $108 resulting in a total interest inclusion for 2006 of $234.50 ($126.50 + $108 = $234.50).

(C) Adjusted issue price and basis. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is ,1210 (,1100 plus ,110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payment and the projected amount of the contingent payment to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) Amount realized. Even though Z receives ,1300 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving ,1210 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, ,100 of the ,1210 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (,1 = $1.05), resulting in an amount realized of $105; ,110 of the ,1210 (representing the interest accrued in 2006) is translated

into dollars at the rate at which it was accrued (,1 = $1.15), resulting in an amount realized of $126.50; and ,1000 of the ,1210 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (,1 = $1), resulting in an amount realized of $1000. Z's total amount realized is $1231.50, the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) Foreign currency gain or loss. Under paragraph (b)(5) of this section Z recognizes foreign currency gain under section 988 on the instrument with respect to the consideration actually received at maturity (except for the net positive adjustment), ,1210. The amount of recognized foreign currency gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in 2005, the foreign currency gain is $15 [,100 x ($1.20 - $1.05)]. With respect to interest accrued in 2006, the foreign currency gain equals $5.50 [,110 x ($1.20 - $1.15)]. With respect to principal, the foreign currency gain is $200 [,1000 x ($1.20 - $1.00)]. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $220.50.

(F) Source. Z has interest income of $105 in 2005, interest income of $234.50 in 2006 (attributable to ,110 of accrued interest and the ,90 net positive adjustment), and a foreign currency gain of $220.50 in 2006. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and '1.988-4, Z=s foreign currency gain of $220.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 2. Treatment of net negative adjustment--(i) Facts. Assume the same facts as in Example 1, except that Z receives ,975 at maturity instead of ,1300.

(ii) Treatment in 2005. The treatment of the debt instrument in 2005 is the same as in Example 1. Thus, Z has interest income in 2005 of $105. On January 1, 2006, the adjusted issue price of the debt instrument is ,1100, and Z's adjusted basis in the instrument is $1105.

(iii) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section and based on the comparable yield, Z's accrued interest for 2006 is ,110 (adjusted issue price of ,1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the ,110 of accrued interest is translated at the average exchange rate for the accrual period ($1.15 x ,110 = $126.50).

(B) Effect of net negative adjustment. The payment actually made on December 31, 2006, is ,975, rather than the projected ,1210. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of ,235 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of ,110 in 2006 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(1) of this section the net negative adjustment which reduces the current year=s interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining ,125 net negative adjustment as an ordinary loss to the extent of the ,100 previously accrued interest in 2005. This ,100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year (,1 = $1.05). Accordingly, Z has an ordinary loss of $105 in 2006. The remaining ,25 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) Adjusted issue price and basis. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is ,1210 (,1100 plus ,110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) Amount realized. Even though Z receives ,975 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of ,25. Therefore, Z is treated as receiving ,1185 (,1210 - ,25) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or

loss) by breaking the amount realized into its component parts. Accordingly, ,100 of the ,1185 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (,1 = $1.05), resulting in an amount realized of $105; ,110 of the ,1185 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (,1 = $1.15), resulting in an amount realized of $126.50; and ,975 of the ,1185 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (,1 = $1), resulting in an amount realized of $975. Z's amount realized is $1206.50 ($105 +$126.50 + $975 = $1206.50), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $25 on retirement of the instrument ($1206.50 - $1231.50 = -$25).

(E) Foreign currency gain or loss. Z recognizes foreign currency gain with respect to the consideration actually received at maturity, ,975. Under paragraph (b)(5)(ii) of this section, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006. In addition, no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Accordingly, Z recognizes foreign currency gain with respect to principal only. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $195 [,975 x ($1.20 - $1.00)].

(F) Source. In 2006, Z has an ordinary loss of $105, a capital loss of $25, and a foreign currency gain of $195. Under paragraph (b)(6) of this section and '1.1275-4(b)(9)(iv), the $105 ordinary loss generally reduces Z=s foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and '1.865-1(b)(2), the $25 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $25 capital loss generally reduces Z=s foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and '1.988-4, Z=s foreign currency gain of $195 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 3. Negative adjustment and periodic interest payments --(i) Facts. On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a two-year debt instrument with a non-currency contingency for ,1000.

All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to '1.1275-4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under ''1.988-2(b)(2) and 1.1275-4(b), is 10 percent, compounded semiannually. The debt instrument provides for semiannual interest payments of ,30 payable each June 30, and December 31, and a contingent payment at maturity on December 31, 2006, which is projected to equal ,1086.20 (consisting of a noncontingent payment of ,980 and a projected payment of ,106.20) in addition to the interest payable at maturity. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in '1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is ,981.00. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	,1.00=$ 1.00
June 30, 2005	,1.00=$ 1.20
Dec. 31, 2005	,1.00=$ 1.40
June 30, 2006	,1.00=$ 1.60
Dec. 31, 2006	,1.00=$ 1.80

Accrual period	Average rate (pounds to dollars)
Jan. - June 2005	,1.00=$ 1.10
July - Dec. 2005	,1.00=$ 1.30
Jan. - June 2006	,1.00=$ 1.50
July - Dec. 2006	,1.00=$ 1.70

(ii) Treatment in 2005--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues ,50 of interest on the debt instrument for the January-June accrual period (issue price of ,1000 x 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the ,50 at the average exchange rate for the accrual period ($1.10 x ,50 = $55.00). Similarly, Z accrues ,51 of interest in the July-December accrual period [(,1000 + ,50 - ,30)

x 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.30 x ,51 = $66.30). Accordingly, Z accrues $121.30 of interest income in 2005.

(B) Adjusted issue price and basis--(1) January-June accrual period. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2005, the adjusted issue price of the debt instrument is ,1020 (,1000 + ,50 - ,30 = ,1020). For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis is increased by the ,50 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.10 x ,50 = $55). The resulting amount is reduced by the ,30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and '1.988-2(b)(7), at the rate applicable to accrued interest ($1.10 x ,30 = $33). Accordingly, Z's adjusted basis as of July 1, 2005, is $1022 ($1000 + $55 - $33).

(2) July-December accrual period. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, on January 1, 2006, the adjusted issue price of the instrument is ,1041 (,1020 + ,51 - ,30 = ,1041). For purposes of determining Z's dollar basis in the debt instrument, the $1022 basis is increased by the ,51 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.30 x ,51 = $66.30). The resulting amount is reduced by the ,30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and '1.988-2(b)(7), at the rate applicable to accrued interest ($1.30 x ,30 = $39). Accordingly, Z's adjusted basis as of January 1, 2006, is $1049.30 ($1022 + $66.30 - $39).

(C) Foreign currency gain or loss. Z will recognize foreign currency gain on the receipt of each ,30 payment of interest actually received during 2005. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(ii) of this section, by reference to the difference between the spot

rate on the date the ,30 payment was made and the average exchange rate for the accrual period during which the interest accrued. Accordingly, Z recognizes $3 of foreign currency gain on the January-June interest payment [,30 x ($1.20 - $1.10)], and $3 of foreign currency gain on the July-December interest payment [,30 x ($1.40 - $1.30)]. Z recognizes in 2005 a total of $6 of foreign currency gain.

(D) Source. Z has interest income of $121.30 and a foreign currency gain of $6. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and '1.988-4, Z=s foreign currency gain of $6 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iii) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for the January-June accrual period is ,52.05 (adjusted issue price of ,1041 x 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the ,52.05 at the average exchange rate for the accrual period ($1.50 x ,52.05 = $78.08). Similarly, Z accrues ,53.15 of interest in the July-December accrual period [(,1041 + ,52.05 - ,30) x 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.70 x ,53.15 = $90.35). Accordingly, Z accrues ,105.20, or $168.43, of interest income in 2006.

(B) Effect of net negative adjustment. The payment actually made on December 31, 2006, is ,981.00, rather than the projected ,1086.20. Under paragraph (b)(2)(ii)(B) of this section, Z has a net negative adjustment of ,105.20 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of ,105.20 in 2006 is reduced to zero by the net negative adjustment. Elimination of the 2006 accrued interest fully utilizes the net negative adjustment.

(C) Adjusted issue price and basis--(1) January-June accrual period. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus,

on July 1, 2006, the adjusted issue price of the debt instrument is ,1063.05 (,1041 + ,52.05 - ,30 = ,1063.05). For purposes of determining Z's dollar basis in the debt instrument, the $1049.30 adjusted basis is increased by the ,52.05 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.50 x ,52.05 = $78.08). The resulting amount is reduced by the ,30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and '1.988-2(b)(7), at the rate applicable to accrued interest ($1.50 x ,30 = $45). Accordingly, Z's adjusted basis as of July 1, 2006, is $1082.38 ($1049.30 + $78.08 - $45).

(2) July-December accrual period. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, immediately before maturity on December 31, 2006, the adjusted issue price of the instrument is ,1086.20 (,1063.05 + ,53.15 - ,30 = ,1086.20). For purposes of determining Z's dollar basis in the debt instrument, the $1082.38 adjusted basis is increased by the ,53.15 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.70 x ,53.15 = $90.36). The resulting amount is reduced by the ,30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and '1.988-2(b)(7), at the rate applicable to accrued interest ($1.70 x ,30 = $51). Accordingly, Z's adjusted basis on December 31, 2006, immediately prior to maturity is $1121.74 ($1082.38 + $90.36 - $51).

(D) Amount realized. Even though Z receives ,981.00 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving ,1086.20 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, ,20 of the ,1086.20 (representing the interest accrued in the January-June 2005 accrual period, less ,30 interest paid) is translated into dollars at the rate at which it was accrued (,1 = $1.10), resulting in an amount realized of $22; ,21 of the ,1086.20 (representing the interest accrued in the

July-December 2005 accrual period, less ,30 interest paid) is translated into dollars at the rate at which it was accrued (,1 = $1.30), resulting in an amount realized of $27.30; ,22.05 of the ,1086.20 (representing the interest accrued in the January-June 2006 accrual period, less ,30 interest paid) is translated into dollars at the rate at which it was accrued (,1 = $1.50), resulting in an amount realized of $33.08; ,23.15 of the ,1086.20 (representing the interest accrued in the July 1-December 31, 2006 accrual period, less the ,30 interest payment) is translated into dollars at the rate at which it was accrued (,1 = $1.70), resulting in an amount realized of $39.36; and ,1000 (representing principal) is translated into dollars at the spot rate on the date the instrument was purchased (,1 = $1), resulting in an amount realized of $1000. Accordingly, Z's total amount realized is $1121.74 ($22 + $27.30 + $33.08 + $39.36 + $1000), the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) Foreign currency gain or loss. Z recognizes foreign currency gain with respect to each ,30 payment actually received during 2006. These payments, however, are treated as payments of principal for this purpose because all 2006 accrued interest is reduced to zero by the net negative adjustment. See paragraph (b)(5)(iv)(A)(3) of this section. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the ,30 payment is made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $18 of foreign currency gain on the January-June 2006 interest payment [,30 x ($1.60 - $1.00)], and $24 of foreign currency gain on the July-December 2006 interest payment [,30 x ($1.80 - $1.00)]. Z separately recognizes foreign currency gain with respect to the consideration actually received at maturity, ,981.00. The amount of such gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in January-June 2005 (other than the ,30 payments), the foreign currency gain is $14 [,20 x ($1.80 - $1.10)]. With respect to the portion of the payment attributable to interest accrued in July-December 2005 (other than the ,30 payments), the foreign currency gain is $10.50 [,21 x ($1.80 - $1.30)]. With respect to the portion of the payment attributable to interest accrued in 2006 (other than the ,30 payments), no foreign currency gain or loss is recognized under

paragraph (b)(5)(ii) of this section because such interest was reduced to zero by the net negative adjustment. With respect to the portion of the payment attributable to principal, the foreign currency gain is $752 [,940 x ($1.80 - $1.00)]. Thus, Z recognizes a foreign currency gain of $42 on receipt of the two ,30 payments in 2006, and $776.50 ($14 + $10.50 + $752) on receipt of the payment at maturity, for a total 2006 foreign currency gain of $818.50.

(F) Source. Under paragraph (b)(6) of this section and '1.988-4, Z=s foreign currency gain of $818.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 4. Purchase price greater than adjusted issue priceB-(i) Facts. On July 1, 2005, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases a debt instrument with a non-currency contingency for ,1405. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to '1.1275-4(b) if it were denominated in dollars. The debt instrument was originally issued by a foreign corporation on December 31, 2003, for an issue price of ,1000, and matures on December 31, 2006. The debt instrument's comparable yield, determined in British pounds under ''1.988-2(b)(2) and 1.1275-4(b), is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date under the rules of '1.1275-4(b)) provides for a single payment at maturity of ,1349.70 (consisting of a noncontingent payment of ,1000 and a projected payment of ,349.70). At the time of the purchase, the adjusted issue price of the debt instrument is ,1161.76, assuming semiannual accrual periods ending on June 30 and December 31 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in '1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is ,1400. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)

July 1, 2005	,1.00=$ 1.00
Dec. 31, 2006	,1.00=$ 2.00

Accrual period	Average rate (pounds to dollars)
July 1 - December 31, 2005	,1.00=$ 1.50
January 1 - June 30, 2006	,1.00=$ 1.50
July 1 - December 31, 2006	,1.00=$ 1.50

(ii) Initial basis. Under paragraph (b)(7)(ii) of this section, Z=s initial basis in the debt instrument is $1405, Z=s purchase price of ,1405, translated into functional currency at the spot rate on the date the debt instrument was purchased (,1 = $1).

(iii) Allocation of purchase price differential. Z purchased the debt instrument for ,1405 when its adjusted issue price was ,1161.76. Under paragraph (b)(7)(iii) of this section, Z allocates the ,243.24 excess of purchase price over adjusted issue price to the contingent payment at maturity. This allocation is reasonable because the excess is due to an increase in the expected amount of the contingent payment and not, for example, to a decrease in prevailing interest rates.

(iv) Treatment in 2005--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues ,59.54 of interest on the debt instrument for the July-December 2005 accrual period (issue price of ,1161.76 x 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the ,59.54 of interest at the average exchange rate for the accrual period ($1.50 x ,59.54 = $89.31). Accordingly, Z has interest income in 2005 of $89.31.

(B) Adjusted issue price and basis. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in July-December 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is ,1221.30 (,1161.76 + ,59.54). For purposes of determining Z's dollar basis in the debt instrument on January 1, 2006, the $1405 basis is increased by the ,59.54 of accrued interest, translated at the rate at which interest was accrued for the July-December 2005 accrual period. Paragraph (b)(3)(iii) of this section. Accordingly, Z's

adjusted basis in the instrument, as of January 1, 2006, is $1494.31 [$1405 + (,59.54 x $1.50)].

(v) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues ,62.59 of interest on the debt instrument for the January-June 2006 accrual period (issue price of ,1221.30 x 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the ,62.59 of accrued interest at the average exchange rate for the accrual period ($1.50 x ,62.59 = $93.89). Similarly, Z accrues ,65.80 of interest in the July-December 2006 accrual period [(,1221.30 + ,62.59) x 10.25 percent/2], which is translated at the average exchange rate for the accrual period ($1.50 x ,65.80 = $98.70). Accordingly, Z accrues ,128.39, or $192.59, of interest income in 2006.

(B) Effect of positive and negative adjustments--(1) Offset of positive adjustment. The payment actually made on December 31, 2006, is ,1400, rather than the projected ,1349.70. Under paragraph (b)(2)(ii) of this section, Z has a positive adjustment of ,50.30 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(7)(iii) of this section, however, Z also has a negative adjustment of ,243.24, attributable to the excess of Z=s purchase price for the debt instrument over its adjusted issue price. Accordingly, Z will have a net negative adjustment of ,192.94 (,50.30 - ,243.24 = -,192.94) for 2006.

(2) Offset of accrued interest. Z's accrued interest income of ,128.39 in 2006 is reduced to zero by the net negative adjustment. The net negative adjustment which reduces the current year=s interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining ,64.55 net negative adjustment as an ordinary loss to the extent of the ,59.54 previously accrued interest in 2005. This ,59.54 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year (,1 = $1.50). Accordingly, Z has an ordinary loss of $89.31 in 2006. The remaining ,5.01 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) Adjusted issue price and basis--(1) January-June accrual period. Under paragraph (b)(2)(iii) of this section, the adjusted

issue price of the debt instrument on July 1, 2006, is ,1283.89 (,1221.30 + ,62.59 = ,1283.89). Under paragraphs (b)(2)(iv) and (b)(3)(iii) of this section, Z's adjusted basis as of July 1, 2006, is $1588.20 ($1494.31 + $93.89).

(2) July-December accrual period. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is ,1349.70 (,1283.89 + ,65.80 accrued interest for July-December). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1686.90 ($1588.20 plus $98.70 of accrued interest for July-December).

(3) Adjustment to basis upon contingent payment. Under paragraph (b)(7)(iii) of this section, Z=s adjusted basis in the debt instrument is reduced at maturity by ,243.24, the excess of Z=s purchase price for the debt instrument over its adjusted issue price. For this purpose, the adjustment is translated into functional currency at the spot rate on the date the instrument was acquired (,1 = $1). Accordingly, Z=s adjusted basis in the debt instrument at maturity is $1443.66 ($1686.90 - $243.24).

(D) Amount realized. Even though Z receives ,1400 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of ,5.01. Therefore, Z is treated as receiving ,1344.69 (,1349.70 - ,5.01) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, ,59.54 of the ,1344.69 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (,1 = $1.50), resulting in an amount realized of $89.31; ,62.59 of the ,1344.69 (representing the interest accrued in January-June 2006) is translated into dollars at the rate at which it was accrued (,1 = $1.50), resulting in an amount realized of $93.89; ,65.80 of the ,1344.69 (representing the interest accrued in July-December 2006) is translated into dollars at the rate at which it was accrued (,1 = $1.50), resulting in an amount realized of $98.70; and ,1156.76 of the ,1344.69 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (,1 = $1), resulting in an amount realized of $1156.76. Z's

amount realized is $1438.66 ($89.31 + $93.89 + $98.70 + $1156.76), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $5 on retirement of the instrument ($1438.66 - $1443.66 = -$5).

(E) Foreign currency gain or loss. Z recognizes foreign currency gain under section 988 on the instrument with respect to the entire consideration actually received at maturity, ,1400. While foreign currency gain or loss ordinarily would not have arisen with respect to ,50.30 of the ,1400, which was initially treated as a positive adjustment in 2006, the larger negative adjustment in 2006 reduced this positive adjustment to zero. Accordingly, foreign currency gain or loss is recognized with respect to the entire ,1400. Under paragraph (b)(5)(ii) of this section, however, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006, and no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Therefore, the entire ,1400 is treated as a return of principal for the purpose of determining foreign currency gain or loss, and Z recognizes a total foreign currency gain on December 31, 2001, of $1400 [,1400 x ($2.00 - $1.00)].

(F) Source. Z has an ordinary loss of $89.31, a capital loss of $5, and a foreign currency gain of $1400. Under paragraph (b)(6) of this section and '1.1275-4(b)(9)(iv), the $89.31 ordinary loss generally reduces Z=s foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and '1.865-1(b)(2), the $5 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $5 capital loss generally reduces Z=s foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and '1.988-4, Z=s foreign currency gain of $1400 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 5. Sale of an instrument with a negative adjustment carryforwardB-(i) Facts. On December 31, 2003, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases at original issue a debt instrument with non-currency contingencies for ,1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to '1.1275-

4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under ''1.988-2(b)(2) and 1.1275-4(b), is 10 percent, compounded annually, and the projected payment schedule for the debt instrument provides for payments of ,310 on December 31, 2005 (consisting of a noncontingent payment of ,50 and a projected amount of ,260) and ,990 on December 31, 2006 (consisting of a noncontingent payment of ,940 and a projected amount of ,50). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in '1.988-2(b)(2)(iii)(B). The payment actually made on December 31, 2005, is ,50. On December 30, 2006, Z sells the debt instrument for ,940. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2003	,1.00=$ 1.00
Dec. 31, 2005	,1.00=$ 2.00
Dec. 30, 2006	,1.00=$ 2.00

Accrual period	Average rate (pounds to dollars)
January 1 - December 31, 2004	,1.00=$ 2.00
January 1 - December 31, 2005	,1.00=$ 2.00
January 1 - December 31, 2006	,1.00=$ 2.00

(ii) Treatment in 2004--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues ,100 of interest on the debt instrument for 2004 (issue price of ,1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the ,100 at the average exchange rate for the accrual period ($2.00 x ,100 = $200). Accordingly, Z has interest income in 2004 of $200.

(B) Adjusted issue price and basis. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2004. Thus, on January 1, 2005, the adjusted issue price of the debt instrument is ,1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 x ,1000 original cost basis) is increased by the ,100 of accrued interest, translated at the rate at which

interest was accrued for 2004. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2005, is $1200 ($1000 + $200).

(iii) Treatment in 2005--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for 2005 is ,110 (adjusted issue price of ,1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the ,110 of accrued interest is translated at the average exchange rate for the accrual period ($2.00 x ,110 = $220).

(B) Effect of net negative adjustment. The payment actually made on December 31, 2005, is ,50, rather than the projected ,310. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of ,260 on December 31, 2005, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of ,110 in 2005 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(1) of this section, the net negative adjustment which reduces the current year=s interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining ,150 net negative adjustment as an ordinary loss to the extent of the ,100 previously accrued interest in 2004. This ,100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year (,1 = $2.00). Accordingly, Z has an ordinary loss of $200 in 2005. The remaining ,50 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) Adjusted issue price and basis. Based on the projected payment schedule, the adjusted issue price of the debt instrument on January 1, 2006 is ,900, i.e., the adjusted issue price of the debt instrument on January 1, 2005 (,1100), increased by the interest accrued in 2005 (,110), and decreased by the projected amount of the December 31, 2005, payment (,310). See paragraph (b)(2)(iii) of this section. Z=s adjusted basis on January 1, 2006 is Z=s adjusted basis on January 1, 2005 ($1200), increased by the functional currency amount of interest accrued in 2005 ($220), and decreased by the amount of the payments made in 2005, based solely on the projected payment schedule, (,310). The amount of the projected payment is first attributable to the interest accrued in 2005 (,110), and then to the interest accrued

in 2004 (,100), and the remaining amount to principal (,100). The interest component of the projected payment is translated into functional currency at the rates at which it was accrued, and the principal component of the projected payment is translated into functional currency at the spot rate on the date the instrument was issued. See paragraph (b)(3)(iii) of this section. Accordingly, Z=s adjusted basis in the debt instrument, following the increase of adjusted basis for interest accrued in 2005 ($1200 + $220 = $1420), is decreased by $520 ($220 + $200 + $100 = $520). Z=s adjusted basis on January 1, 2006 is therefore, $900.

(D) Foreign currency gain or loss. Z will recognize foreign currency gain on the receipt of the ,50 payment actually received on December 31, 2005. Based on paragraph (b)(5)(iv) of this section, the ,50 payment is attributable to principal since the accrued unpaid interest was completely eliminated by the net negative adjustment. The amount of foreign currency gain is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the ,50 payment was made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $50 of foreign currency gain on the ,50 payment. [($2.00 - $1.00) x ,50 =$50]. Under paragraph (b)(6) of this section and '1.988-4, Z=s foreign currency gain of $50 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iv) Treatment in 2006--(A) Determination of accrued interest. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues ,90 of interest on the debt instrument for 2006 (adjusted issue price of ,900 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the ,90 at the average exchange rate for the accrual period ($2.00 x ,90 = $180). Accordingly, prior to taking into account the 2005 negative adjustment carryforward, Z has interest income in 2006 of $180.

(B) Effect of net negative adjustment. The ,50 negative adjustment carryforward from 2005 is a negative adjustment for 2006. Since there are no other positive or negative adjustments, there is a ,50 negative adjustment in 2006 which reduces Z=s accrued interest income by ,50. Accordingly, after giving effect to the ,50 negative adjustment carryforward, Z will accrue $80 of interest income. [(,90-,50) x $2.00 = $80]

(C) Adjusted issue price. Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument determined in pounds is increased by the interest accrued in 2006 (prior to taking into account the negative adjustment carryforward). Thus, on December 30, 2006, the adjusted issue price of the debt instrument is ,990.

(D) Adjusted basis. For purposes of determining Z's dollar basis in the debt instrument, Z=s $900 adjusted basis on January 1, 2006, is increased by the accrued interest, translated at the rate at which interest was accrued for 2006. See paragraph (b)(3)(iii)(A) of this section. Note, however, that under paragraph (b)(3)(iii)(B) of this section the amount of accrued interest which is reduced as a result of the negative adjustment carryforward, i.e., ,50, is treated for purposes of this section as principal, and is translated at the spot rate on the date the instrument was issued, i.e., ,1.00 =$1.00. Accordingly, Z's adjusted basis in the debt instrument as of December 30, 2006, is $1030 ($900 + $50 + $80).

(E) Amount realized. Z=s amount realized in denomination currency is ,940, i.e., the amount of pounds Z received on the sale of the debt instrument. Under paragraph (b)(3)(iv)(B)(1) of this section, Z=s amount realized is first translated by reference to the principal component of basis (including the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section) and then the remaining amount realized, if any, is translated by reference to the accrued unpaid interest component of adjusted basis. Thus, ,900 of Z=s amount realized is translated by reference to the principal component of adjusted basis. The remaining ,40 of Z=s amount realized is treated as principal under paragraph (b)(3)(iii)(B) of this section, and is also is translated by reference to the principal component of adjusted basis. Accordingly, Z=s amount realized in functional currency is $940. (No part of Z=s amount realized is attributable to the interest accrued on the debt instrument.) Z realizes a loss of $90 on the sale of the debt instrument ($1030 basis - $940 amount realized). Under paragraph (b)(4) of this section and '1.1275-4(b)(8), $80 of the loss is characterized as ordinary loss, and the remaining $10 of loss is characterized as capital loss. Under ''1.988-6(b)(6) and 1.1275-4(b)(9)(iv) the $80 ordinary loss is treated as a deduction that is definitely related to the interest income accrued on the debt instrument. Similarly, under ''1.988-6(b)(6) and 1.865-1(b)(2) the $10 capital loss is also allocated to the interest income from the debt instrument.

(F) Foreign currency gain or loss. Z recognizes foreign currency gain with respect to the ,940 he received on the sale of the debt instrument. Under paragraph (b)(5)(iv) of this section, the ,940 Z received is attributable to principal (and the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section). Thus, Z recognizes foreign currency gain on December 31, 2006, of $940. [($2.00-$1.00) x ,940]. Under paragraph (b)(6) of this section and '1.988-4, Z=s foreign currency gain of $940 is sourced by reference to Z's residence and is therefore from sources within the United States.

(d) Multicurrency debt instruments--(1) In general. Except as provided in this paragraph (d), a multicurrency debt instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be treated as an instrument described in paragraph (a)(1)(i) of this section and shall be accounted for under the rules of paragraph (b) of this section. Because payments on an instrument described in paragraph (a)(1)(ii) or (iii) of this section are denominated in, or determined by reference to, more than one currency, the issuer and holder or holders of the instrument are required to determine the denomination currency of the instrument under paragraph (d)(2) of this section before applying the rules of paragraph (b) of this section.

(2) Determination of denomination currency--(i) In general. The denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be the predominant currency of the instrument. Except as otherwise provided in paragraph (d)(2)(ii) of this section, the predominant currency of the instrument shall be the currency

with the greatest value determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary) into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (e.g., changes in value of one or more currencies).

(ii) Difference in discount rate of greater than 10 percentage points. This §1.988-6(d)(2)(ii) applies if no currency has a value determined under paragraph (d)(2)(i) of this section that is greater than 50% of the total value of all payments. In such a case, if the difference between the discount rate in the denomination currency otherwise determined under (d)(2)(i) of this section and the discount rate determined under paragraph (d)(2)(i) of this section with respect to any other currency in which payments are made (or determined by

reference to) pursuant to the instrument is greater than 10 percentage points, then the Commissioner may determine the predominant currency under any reasonable method.

(3) Issuer/holder consistency. The issuer determines the denomination currency under the rules of paragraph (d)(2) of this section and provides this information to the holders of the instrument in a manner consistent with the issuer disclosure rules of '1.1275-2(e). If the issuer does not determine the denomination currency of the instrument, or if the issuer=s determination is unreasonable, the holder of the instrument must determine the denomination currency under the rules of paragraph (d)(2) of this section. A holder that determines the denomination currency itself must explicitly disclose this fact on a statement attached to the holder=s timely filed federal income tax return for the taxable year that includes the acquisition date of the instrument.

(4) Treatment of payments in currencies other than the denomination currency. For purposes of applying the rules of paragraph (b) of this section to debt instruments described in paragraph (a)(1)(ii) or (iii) of this section, payments not denominated in (or determined by reference to) the denomination currency shall be treated as non-currency-related contingent payments. Accordingly, if the denomination currency of the instrument is determined to be the taxpayer=s functional

currency, the instrument shall be accounted for under '1.1275-4(b) rather than under this section.

(e) Instruments issued for nonpublicly traded property--(1) Applicability. This paragraph (e) applies to debt instruments issued for nonpublicly traded property that would be described in paragraph (a)(1)(i), (ii), or (iii) of this section, but for the fact that such instruments are described in '1.1275-4(c)(1) rather than '1.1275-4(b)(1). For example, this paragraph (e) generally applies to a contingent payment debt instrument denominated in a nonfunctional currency that is issued for non-publicly traded property. Generally the rules of '1.1275-4(c) apply except as set forth by the rules of this paragraph (e).

(2) Separation into components. An instrument described in this paragraph (e) is not accounted for using the noncontingent bond method of '1.1275-4(b) and paragraph (b) of this section. Rather, the instrument is separated into its component payments. Each noncontingent payment or group of noncontingent payments which is denominated in a single currency shall be considered a single component treated as a separate debt instrument denominated in the currency of the payment or group of payments. Each contingent payment shall be treated separately as provided in paragraph (e)(4) of this section.

(3) Treatment of components consisting of one or more noncontingent payments in the same currency. The issue price of

each component treated as a separate debt instrument which consists of one or more noncontingent payments is the sum of the present values of the noncontingent payments contained in the separate instrument. The present value of any noncontingent payment shall be determined under '1.1274-2(c)(2), and the test rate shall be determined under '1.1274-4 with respect to the currency in which each separate instrument is considered denominated. No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of '1.1273-1(c)) and the de minimis rules of section 1273(a)(3) and '1.1273-1(d) do not apply to the separate debt instrument. Interest income or expense is translated, and exchange gain or loss is recognized on the separate debt instrument as provided in '1.988-2(b)(2), if the instrument is denominated in a nonfunctional currency.

(4) Treatment of components consisting of contingent payments --(i) General rule. A component consisting of a contingent payment shall generally be treated in the manner provided in '1.1275-4(c)(4). However, except as provided in paragraph (e)(4)(ii) of this section, the test rate shall be determined by reference to the U.S. dollar unless the dollar does not reasonably reflect the economic substance of the contingent component. In such case, the test rate shall be determined by reference to the currency which most reasonably reflects the

economic substance of the contingent component. Any amount received in nonfunctional currency from a component consisting of a contingent payment shall be translated into functional currency at the spot rate on the date of receipt. Except in the case when the payment becomes fixed more than six months before the payment is due, no foreign currency gain or loss shall be recognized on a contingent payment component.

(ii) Certain delayed contingent payments--(A) Separate debt instrument relating to the fixed component. The rules of '1.1275-4(c)(4)(iii) shall apply to a contingent component the payment of which becomes fixed more than 6 months before the payment is due. For this purpose, the denomination currency of the separate debt instrument relating to the fixed payment shall be the currency in which payment is to be made and the test rate for such separate debt instrument shall be determined in the currency of that instrument. If the separate debt instrument relating to the fixed payment is denominated in nonfunctional currency, the rules of '1.988-2(b)(2) shall apply to that instrument for the period beginning on the date the payment is fixed and ending on the payment date.

(B) Contingent component. With respect to the contingent component, the issue price considered to have been paid by the issuer to the holder under '1.1275-4(c)(4)(iii)(A) shall be translated, if necessary, into the functional currency of the

issuer or holder at the spot rate on the date the payment becomes fixed.

(5) Basis different from adjusted issue price. The rules of '1.1275-4(c)(5) shall apply to an instrument subject to this paragraph (e).

(6) Treatment of a holder on sale, exchange, or retirement. The rules of '1.1275-4(c)(6) shall apply to an instrument subject to this paragraph (e).

(f) Rules for nonfunctional currency tax exempt obligations described in '1.1275-4(d)--(1) In general. Except as provided in paragraph (f)(2) of this section, section 1.988-6 shall not apply to a debt instrument the interest on which is excluded from gross income under section 103(a).

(2) Operative rules. [RESERVED].

(g) Effective date. This section shall apply to debt instruments issued on or after October 29, 2004.

Par. 5. In §1.1275-2, paragraph (g)(1) is amended by adding a sentence at the end of the paragraph to read as follows:

§1.1275-2 Special rules relating to debt instruments.

* * * * * *

(g) * * * (1) * * * See also §1.988-2(b)(18) for debt instruments with payments denominated in (or determined by

reference to) a currency other than the taxpayer's functional currency.

* * * * *

Par. 6. In '1.1275-4, paragraph (a)(2)(iv) is revised to read as follows:

'1.1275-4 Contingent payment debt instruments.

(a) * * *

(2) * * *

(iv) A debt instrument subject to section 988 (except as provided in '1.988-6);

* * * * *

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

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. Section 601.101, paragraph (b) is amended by adding an entry to the table in numerical order to read, in part,as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.988-6	1545-1831
* * * * *	

Nancy Jardine,
Acting Deputy Commissioner of Services and Enforcement.

Approved: July 16, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

August 31, 2004
js-1879

Secretary Snow Visits Philadelphia Friday

U.S. Treasury Secretary John Snow will visit Philadelphia, Pennsylvania on Friday, September 3 to meet with local business leaders and discuss President Bush's efforts to strengthen the economy and create jobs.

"More than 4.6 million taxpayers in Pennsylvania will have lower income tax bills in 2004 as a result of President Bush's economic policies. There is no doubt that those policies are driving job growth in Pennsylvania and across the country," said Secretary Snow.

Recent economic reports indicate that the economy has turned around and job creation is on the rise. According to the Labor Department, nationwide nearly 1.5 million jobs have been created since August 2003 according to the payroll survey; and 2.3 million jobs have been created since August 2003 according to the household survey. The national unemployment rate declined to 5.5% in July – down 0.8 percentage points from a peak of 6.3% in June 2003 and the lowest rate since October 2001. At 5.5%, the unemployment rate is below the average of the 1970s, 1980s, and 1990s. Job creation was up in 46 of the 50 states in the last year, and the unemployment rate was down in all regions and in 49 of the 50 states.

During his trip to Pennsylvania, Secretary Snow will also discuss the Bush Administration's efforts to control health care costs, reduce frivolous lawsuits and ensure that America has reliable and affordable sources of energy. "While the economy is on solid footing, we are not satisfied and there is still more work to be done. We must continue to push forward on a pro-growth economic agenda that meets the needs of the American people," Secretary Snow said.

The following events are open to the press, which must present a media credential with photo identification to obtain admittance:

Friday, September 3, 2004

9:30 am - 10:30 am
EVENT: Roundtable discussion with Secretary Snow and area builders and contractors
Southeast Pennsylvania Chapter of the Association of Builders and Contractors
430 West Germantown Pike
East Norriton, PA 19403
610-279-6666

10:30 am - 11:00 am
EVENT: Press availability with Secretary Snow immediately following the roundtable discussion